The Absolute Return Letter
July 2010

The Art of Outperformance

"When data contradicts theory in a discipline like physics, there is excitement amongst scientists [...]. When data contradicts theory in finance, there is dismissal."

Robert Arnott

Big shift to passive

Active management in the equity field is a notoriously difficult art. In fact so difficult that more and more investors give up and go passive instead. If you can't beat them, join them. In the US alone, retail investors have withdrawn about $350 billion from active equity managers in the past two years and instead pumped $500 billion into passive investment vehicles (mostly ETFs)[1]. Retail investors are not alone. Sovereign wealth funds, endowments and pension funds are all allocating ever larger amounts to passive instruments. By one estimate, some $4 trillion worth of actively managed assets will switch to passive management over the next 5 years[1].

Behind this flight to armchair investing lies a growing realisation that the majority of active managers will never consistently beat the index. Newly published research from Standard & Poors[2] suggests that for the five year period ending 31 December, 2009, only 39% of active large cap managers outperformed the S&P500. In mid- and small-cap, the problem was even more pronounced with only 23% and 33% outperforming the respective benchmarks.

It all began with Harry Markowitz, Eugene Fama and the efficient market hypothesis, developed back in the 1950s. A decade later, when William Sharpe published his work on the capital asset pricing model (CAPM) on the basis of Markowitz's and Fama's earlier work, it gradually became accepted that it is near impossible for most mortals to outperform the market (Warren Buffett is obviously not a mere mortal). Hence the foundation for passive investing, index funds and ETFs was laid.

The irony of all of this of course is that ultimately the growth of passive investments will create anomalies and inefficiencies. Stock prices will be driven more by inclusion/exclusion in the indices than by the intrinsic value. For stock pickers, such an environment is likely to create enormous opportunities. But we are not there yet. For the time being, in the equity arena, index products are likely to continue to outperform the majority of active managers.

Why most managers underperform

So why do most active equity managers underperform? Many a research paper has been written on this subject, and I am not particularly keen to add to an already long list. I think it is far more interesting to look for solutions, so I shall answer the question only superficially. The most

[1] *"Exploiting Uncertainty in Investment Markets", CREATE Research, 2010. You can find the full report here: here*

[2] *S&P Indices, Research Insights, March 2010. You can find the full report here.*

obvious reason is cost. Between management fees, performance fees (sometimes), trading costs, custody and admin fees, active managers often start the year being behind by 2% or more. Not easy.

However, cost alone does not explain the difference between active and passive managers; if it did, active managers would consistently underperform and that is not the case. 'Herding' is another reason. We are all prone to it. Herding manifests itself in a number of different ways. For example, investors tend to fall in love with the same investment ideas, which can drive valuations up in the short to medium term but cause over-crowding longer term and ultimately lead to a collapse in valuations (think dotcom). In the survey conducted by CREATE Research, asset managers from all over the world were asked which markets would be expected to grow the fastest and which would offer the best opportunities for alpha going forward.

Chart 1: CREATE Research Survey on Market Opportunities

Source: CREATE Research

The response, which is shown in chart 1 above, speaks for itself. Not surprisingly, most of us have fallen in love with Asia. It is hard to disagree that Asia looks likely to deliver higher growth than both Europe and North America in the years to come; however, to conclude on that basis that Asia will also offer the best opportunities for alpha may be a step too far. This is an example where unrestricted affection for a particular market may have clouded the minds of investors – a classic example of herding.

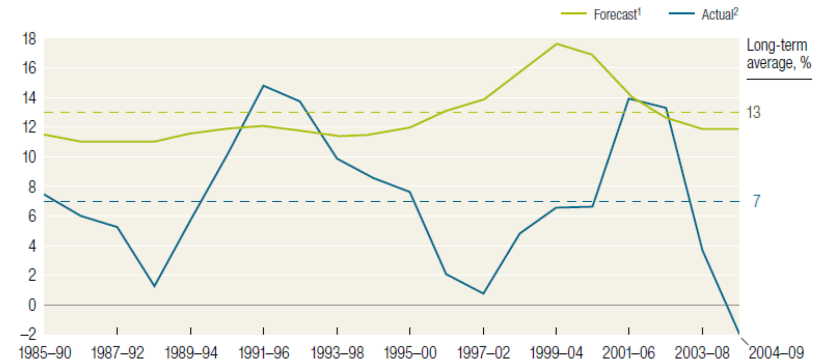
Sell-side analysts offer another example of herding (see chart 2). Analysts are prone to herding and so are investors relying on those estimates to drive investment decisions. The result? Performance which fails to live up to expectations.

Yet another factor impacting the relative performance of active managers is the so-called 'size premium'. Let me illustrate this phenomenon with a simple example[3]: The largest stock in the S&P500 is Exxon with a market cap of $293 billion. The smallest one is New York Times which is valued at just over $1 billion. An index fund would allocate $293 to Exxon for every

[3] *Source: "Why active fund managers often underperform the S&P500: The Impact of size and skewness", which you can find here.*

dollar allocated to New York Times. An active manager would *never* go to that extreme in terms of how the money is allocated. This has the potential to cause large deviations in relative performance between active and passive managers. In periods where large cap stocks outperform small cap stocks – as has been the case in recent years – the active manager will underperform the index.

Chart 2: Earnings Growth for S&P500 – Actual vs. Forecast



[1]Analysts' 5-year forecasts for long-term consensus earnings-per-share (EPS) growth rate. Our conclusions are same for growth based on year-over-year earnings estimates for 3 years.
[2]Actual compound annual growth rate (CAGR) of EPS; 2009 data are not yet available, figures represent consensus estimate as of Nov 2009.

Source: Thomson Reuters I/B/E/S Global Aggregates; McKinsey analysis

A somewhat more technical factor is what statisticians call skewness – the fact that in most years stock returns are not normally distributed but skewed to the right (more positive than negative observations). This asymmetry causes a headache for active managers, because they tend to hold only a small subset of the underlying market. Again, this is best illustrated through a simple example: In a given year, imagine that 499 of the 500 stocks in the S&P500 are flat, whereas the last one is up 500%. Consequently, the index will be up 1%. Now consider two active managers who each elect to invest in 50 of the 500 stocks. One is lucky/smart enough to include the high performer; the other one is not. The first one will be up 10% whereas the second one will show a performance of 0% for the year.

Although the example is not entirely realistic, it illustrates the 'dangers' of small portfolios. The academics amongst us would say that, because of the right skewness of returns, the median return in the portfolio will underperform the mean return. This is another way of saying that it is hard to beat the market!

Enough said about the reasons most active managers underperform. If you want to read more about this topic, go to the research library on our website www.arpllp.com, where I have filed some research. Now to the solutions, and this is where things get interesting. In the following, I will offer two possible solutions to investors who are struggling to beat the index. Both are universal in nature, so don't stop reading just because you are based in Timbuktu. They work *everywhere*.

Fundamental Indexing

The first one is based on the Fundamental Index® concept. The problem with a normal index fund is that capital is disproportionately allocated to overvalued stocks. The higher the stock price goes, the higher the weight in the index fund. In effect, investors chase yesterday's winners all the time.

The Fundamental Index concept has been developed by Research Affiliates in Newport Beach, California, under the guidance and leadership of Robert Arnott, one of the leading lights of our industry. The Fundamental Index approach uses other measures of size instead of market cap. Interestingly, it matters less which one(s) you choose. As you can see from chart 3 below, book value, cash flow, sales and dividends, when used as index weights, have all outperformed the S&P500 significantly over the past half century.

If you don't get excited about an annual outperformance in the region of 2-2.5% per year you miss the point. A good friend of mine with strong actuarial skills recently told me the following tale: Imagine you divide up your life into 3 parts – 0-30, 30-60 and 60-90. Almost all your retirement savings will by definition fall into the second stage. If you can increase the annual return on your retirement portfolio by just 1% per annum during that 30 year period, you will have saved 1/3 more by the time your reach retirement. Wouldn't you take that any time?

Chart 3: Fundamental vs. Traditional Indexing – 1962-2009

Index	Ending Value of $1	Annual Return	Volatility	Sharpe Ratio	Tracking Error
S&P 500	$ 72	9.3%	15.1%	0.27	1.7%
Cap 1000	$ 72	9.3%	15.3%	0.27	--
Book	$146	10.9%	15.5%	0.36	4.0%
Cash Flow	$189	11.5%	15.4%	0.40	4.2%
Sales	$225	11.9%	16.3%	0.41	5.2%
Gross Dividend	$153	11.0%	14.3%	0.39	5.5%
RAFI Composite	$182	11.5%	15.3%	0.40	4.4%

Source: Research Affiliates LLC

Outside the United States, the concept works even better. Chart 4 contains data for different regions of the world and, as you can see, the value added has been substantially bigger in both Europe and Asia. Emerging markets have done best of all with an annual outperformance of almost 10%.

This does not imply that a Fundamental Index approach always outperforms traditional indexing. As you can see on the right hand side of chart 4, there are times when it underperforms. In momentum driven markets for example, it may underperform – perhaps even significantly so. In that respect, a Fundamental Index approach is not unlike value investing which often underperforms in momentum markets.

Some high profile academics have actually criticised the Fundamental Index approach for being no more than value investing in disguise. Whilst it is correct that there is a value tilt in a Fundamental Index portfolio, just as there is a growth tilt in a traditional index portfolio, there are also fundamental differences. For example, in the strong growth years of 1962 to 1969, a fundamentally weighted portfolio outperformed conventional indexing, whereas value investors underperformed growth investors[4].

It has even been suggested that the Fundamental Index concept will not stand the test of time. Admittedly, should the entire world convert from conventional to fundamentally weighted indices, the two will become one and the same thing and the excess returns will disappear. However, given the enormous amounts currently invested in traditional index products, it will take many years before we approach that situation. Therefore the negativity surrounding the Fundamental Index concept emanating from certain quarters smacks of sour grapes. It is quite simply an idea which is simple and brilliant in equal measures.

[4] *Source: "An Overwrought Orthodoxy", Institutional Investor, December 2006*

Chart 4: Global Performance of Fundamental Indexing (Dec. 2009)

	Start Date	Annualized Return	Annualized Volatility	Annualized Value Add	% 3-Year Wins
Simulated RAFI US Large	1962	11.5%	15.3%	2.2%	73.9%
S&P 500	(48 years)	9.3%	15.1%		
Simulated RAFI Developed 1000	1984	12.7%	15.0%	2.9%	83.8%
MSCI Global	(26 Years)	9.9%	15.5%		
Simulated RAFI Japan	1984	5.3%	19.7%	3.2%	91.0%
MSCI Japan	(26 Years)	2.1%	20.1%		
Simulated RAFI U.S. Small	1979	15.4%	19.7%	4.1%	99.7%
Russell 2000	(31 Years)	11.3%	19.9%		
Simulated RAFI Europe	1984	15.2%	18.1%	4.7%	72.9%
MSCI Europe	(26 Years)	10.5%	16.4%		
Simulated RAFI Int'l. Small 1500	1999	13.7%	17.3%	5.7%	95.9%
MSCI EAFE Small Cap	(11 Years)	8.0%	19.2%		
Simulated RAFI EM	1994	16.2%	25.4%	9.9%	96.2%
MSCI EM	(16 Years)	6.4%	24.8%		

Source: Research Affiliates LLC

Warren Buffett on steroids

The second solution (which I will call REAP in the following - the Real Equity Alpha Portfolio), is based on the assumption that the true value of a company is difficult to establish. This is due to the fact that almost all investors base their investment decisions on forward looking estimates rather than real facts as input. Value investors tend to focus more on the quality of the balance sheet (they look for what they call intrinsic value) and put less emphasis on earnings power. Growth investors, on the other hand, focus almost exclusively on earnings power. REAP focuses on both earnings power and financial strength through a highly disciplined quantitative approach.

Conceptually, we think of it as 'Warren Buffett on steroids'. The idea is to mirror the very best of the fundamental research style and approach that Warren Buffett has brought to the world of investments but, at the same time, to 'automate' the process so that every listed stock in the world is subject to scrutiny. Although it is in principle an active strategy, it differs from most active managers in a number of ways: There is no use of earnings estimates, valuation is not an investment criteria, benchmarking is meaningless and market timing is not used. Furthermore, there is no leverage involved, the process is fully transparent and the portfolio is very liquid.

REAP calculates more than 400 million key ratios annually from a database containing over 100,000 listed companies around the world. Each company is then rated on the basis of the combined score and REAP invests in the top 50 names.

Chart 5: Track Record of REAP

Long Only Portfolios	Since*	Benchmark (BM)	BM avg. return	REAP Annual Return	Outperformance Ratio**
Global	2000	MSCI World	-1.2%	11.7%	90%
US	2000	S&P-500	-0.2%	14.2%	87%
Europe	2000	Stoxx-600	-3.6%	9.1%	90%

* *Real portfolio on European equities 2005-2009. Other portfolio returns are proforma, using the same investment approach.*

** *Outperformance ratio = Percentage of years outperforming relative to benchmark.*

The investment concept has been up and running for some years, delivering excellent performance – see chart 5. Our intention is to launch a global fund. We are currently looking for seed investors. Call us if you want to hear more.

At Absolute Return Partners, we pride ourselves on 'Outside the Box' solutions. Long term followers of our firm will have noticed that we haven't done much historically in the equity space. The reason is simple – we didn't believe we could add much value. This is about to change. We have done a lot of research in recent months and believe we have come up with some interesting solutions. We see no need to settle for a plain vanilla index fund if there are more interesting alternatives available.

We have given you two possible solutions today. Give us a call on +44 20 8939 2900 or send an email to info@arpllp.com if any of this has whetted your appetite. In the meantime, enjoy the summer. Something is astray here in London. Wimbledon is on *and* the weather is good. Better enjoy it while it lasts. We will be back with another Absolute Return Letter on or around 1st September.

Niels C. Jensen

Note: *The trade names Fundamental Index®, RAFI®, and the Research Affiliates corporate name and logo are registered trademarks and are the exclusive intellectual property of Research Affiliates, LLC.*

Important Notice

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We are a company with a simple mission – delivering superior risk-adjusted returns to our clients. We believe that we can achieve this through a disciplined risk management approach and an investment process based on our open architecture platform.

Our focus is strictly on absolute returns. We use a diversified range of both traditional and alternative asset classes when creating portfolios for our clients.

We have eliminated all conflicts of interest with our transparent business model and we offer flexible solutions, tailored to match specific needs.

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