STYLE RESEARCH

GLOBAL EQUITY RESEARCH AND PORTFOLIO ANALYSIS

Summer 2007 Newsletter

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Has Value Run Out of Steam?

Returns of Value-biased portfolios have been very favourable over the last few years. In the time since the internet bubble, the recovery in 'cheaper' stocks has more than compensated for the rout at the end of the 1990s. The **figure 1** chart, created in *Style Research Online,* illustrates the situation. Every month, from a universe of the largest 2,000 stocks, across 24 Developed markets, we have selected the top half of each local industry, screened by a Value composite (an equally weighted mix of Book to Price, Earnings Yield and Dividend Yield). The cap-weighted gross returns of this Value-biased, but diversified, sector and country neutral, portfolio are shown relative to the overall universe.

This simple strategy has outperformed by over 30% since Q1 2000, but performance has tailed off over the last couple of years. Is this the end of the road for Value and an opportunity for other strategies? One clue may be the degree to which value characteristics differ across the market. Using the universe defined earlier we show the cross sectional standard deviation of Book to Price and Earnings Yield over time.

When this is high, there is a big spread between the cheapest and most expensive stocks and perhaps a greater chance of mis-pricing; when it is low, fewer opportunities may exist for Value. Currently, we can see in **figure 2** that the spreads are at levels not seen since before the bubble.

Another indicator is the 'growth' of Value stocks. **Figure 3** shows the difference in earnings growth between high and low Value stocks.

This has been positive for *historic* EPS growth for much of the period since the turn of the century. That is to say, despite being 'cheaper,' the stocks in our high Value portfolio have been delivering

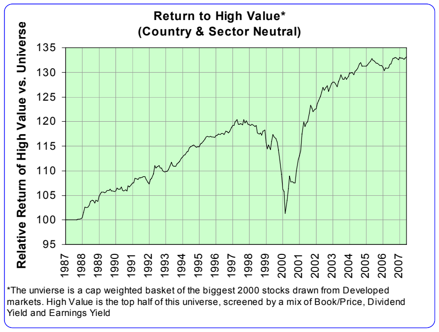

FIGURE 1 *(Source: Style Research Online)*

better growth than low Value (i.e. traditional 'Growth' stocks). However, this has dipped into negative territory recently, approaching pre-bubble levels. Also shown is the *forecast* EPS growth of high vs. low Value. This has been consistently negative, which makes sense. After all, Value stocks are often priced more cheaply because they are expected to deliver relatively poor growth. Currently, the difference is around average historic

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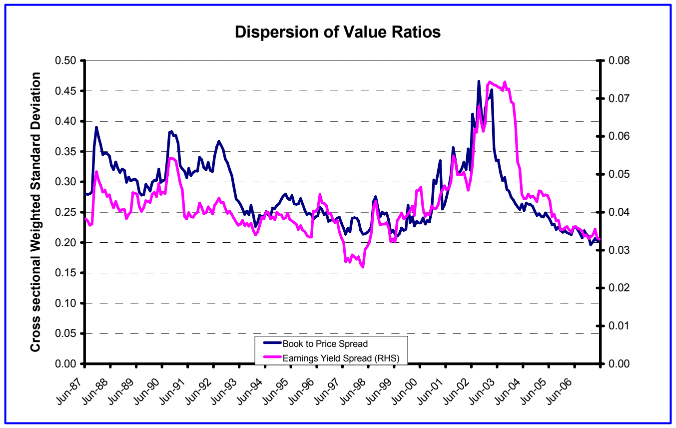

FIGURE 2 *(Source: Style Research Online)*

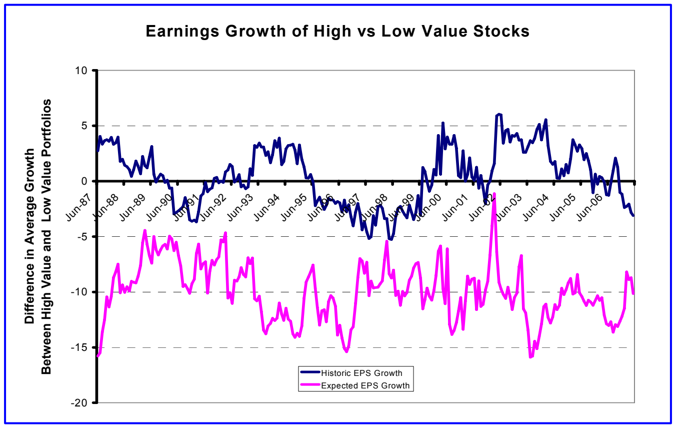

FIGURE 3 *(Source: Style Research Online)*

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STYLE RESEARCH OPENS CANADIAN OFFICE

Style Research opened its new Canadian office in Toronto on June 1, appointing **Ian Nisbet** as Chief Operating Officer and Head of Canadian operations.

"We have seen a rapid increase in North American clients, so far developed from our existing US office in Boston, and are now committed to providing further support for our Canadian clients and to growing our Canadian operations," said Bernie Nelson, President of Style Research in North America.

Ian Nisbet joins Style Research from Brockhouse Cooper in Montréal, where he worked as a Transition Manager serving the Canadian institutional plan sponsor community. Prior to this, Ian was a Senior Consultant with Barra International in New York and London.

Ian Nisbet can be contacted directly at +1 647 801 8871 or ian.nisbet@styleresearch.com

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levels, but is much lower than the near parity in expectations seen during the height of the Value rally. So in terms of trend, valuation and earnings growth, Value stocks don't appear to be very attractive. Is this the time for a Growth stock recovery?

Traditionally, Growth has performed episodically. Higher interest rates on the horizon may make earnings growth less plentiful, with growth stocks that actually deliver on their expectations being rewarded as a consequence. But a steepening yield curve is not usually favourable to Growth and the recent strong equity market returns are unlikely to continue in an environment of further tightening. However, in the event of a market correction, Growth is unlikely to suffer in the same way as at previous retrenchments – frothy Growth stocks have not been the drivers of the market of late.

Looking at the performance of a variety of Value and Growth factors over the past three months in **figure 4**, there is now clearer evidence of emerging strength in a number of key Growth factors. While the Value factors are not universally underperforming, Value returns are more variable and the stronger patterns are now appearing within Growth. It is important to note, however, that the strongest elements appear among Growth companies with favourable current P&Ls and recent strength of earnings rather than those requiring a longer horizon of favourable economic conditions. ■ ■ ■

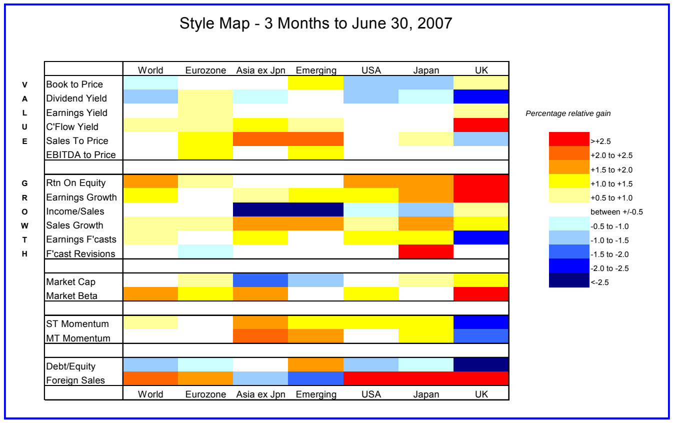


FIGURE 4

Development of Peer Group Analysis

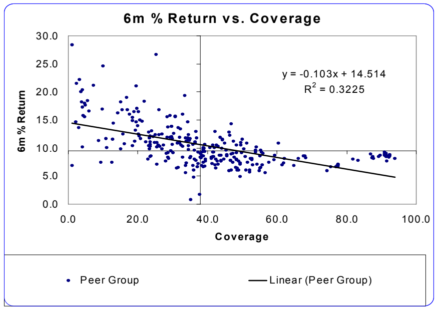
Our Peer Group Analysis product allows the comparison of funds against each other without the need for users to load in the fund holdings. A large universe of funds has been preloaded by Style Research and the results produced in one easy-to-use application. Users can construct their own peer groups and examine the differences between funds, using the same factors found in the Style Research Portfolio Analyzer.

The database of portfolios has doubled since our last newsletter and now exceeds 2,800 with a total analysis of over 26,000 fund time points. Now the application includes funds registered for sale within Europe and the UK; but, development of a North American database is well underway.

A number of additional reports have been added to the application. These now include the standard Style Skyline™ and also a returns chart, which compares the NAV returns of the portfolios over time. We have also expanded the number of filter options; one is the range for each filter to help guide users.

Work has already begun on the next stage of development, which is transferring the existing product onto a web platform. This will offer even more potential to improve the service. We will update you on this progress later in the year.

The scatter chart in the Peer Group Analysis product can provide some useful insights on patterns within the funds market. For example, funds with low Coverage (the % overlap between portfolio and benchmark) have generally performed better. This analysis supports the work of Cremers and Petajisto, published last year in the Journal of Economic Literature. The Peer Group Analysis scatter chart shows that the phenomenon they first discovered in the United States appears also to be evident in the United Kingdom. ■ ■ ■



NEW STAFF MEMBERS AT STYLE RESEARCH

Style Research is pleased to welcome two new members of staff to the London office:

Debasish Dutta—BSc. Honours Mathematics, Calcutta University; Microsoft Certified Professional—joins as a senior developer.

Luz Zambrano Portilla—MA Bilingual Translation, Westminster University; MA Marketing, London Metropolitan University; BSc. Engineering, Universidad Autonoma de Occidente, Colombia—joins as office manager.

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What's Happened to Risk?

An interesting picture emerges when looking at UK equity managers within the *Style Research Peer Group Analysis* (*SRPGA*) service. As **figure 1** demonstrates, tracking error levels have fallen over the last couple of years. Indeed. the dispersion of tracking error across managers has also decreased over the period.

Have managers lost their appetite for risk? Before answering, it's worth examining the volatility of the market as a whole. **Figure 2** shows that both the ex ante risk (calculated by the *Style Research Portfolio Analyzer*) and the ex post risk (from *Style Research Online*) have been falling over the period for UK stocks. In fact, the drop of 20% in levels is more than the fall in the risk of the average manager over the period.

This may be corroborated by comparing the tracking errors of today's funds calculated using the latest risk model with that of two years ago. **Figure 3** shows that risk levels, using today's holdings, would indeed have been around 20% higher if the risk model from 2005 were employed.

So, the initial chart camouflaged the real underlying trend. It seems likely that as overall market volatility levels have fallen, managers have attempted to seek out more sources of risk to keep up their active risk levels. Further analysis of *Style Research Peer Group Analysis* output indicates that this has not in general come from top down bets such as Sector or Style views.

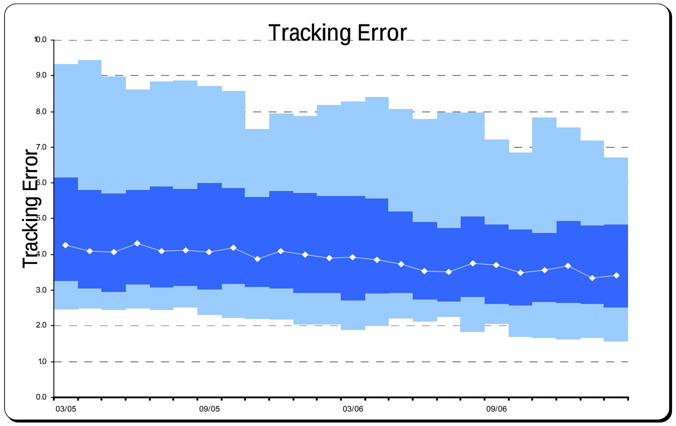

FIGURE 1

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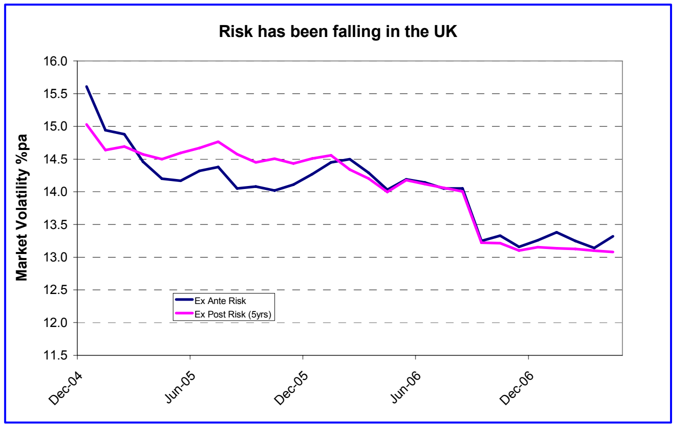

FIGURE 2

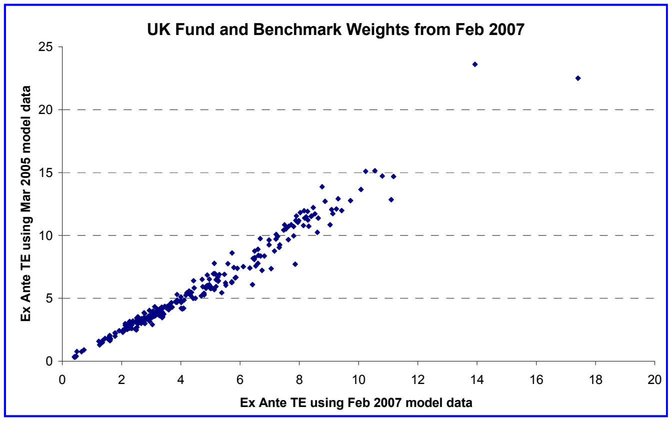

FIGURE 3

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For example, as shown in **figure 4**, the active positions in Styles have diminished. This is especially so for Large Growth where the underweight has been reduced, and at a time when the volatility of Styles has also been dropping. One consequence of this is that the amount of risk from bottom up stock selection has risen. The next chart confirms this.

Again taken from *Style Research Peer Group Analysis*, **figure 5** reveals that there has been a big increase in the proportion of tracking error arising from bottom up stock risk. Two years ago, the median manager derived less than half their risk from stock-picking. Now it is above 60%. And this has been reinforced by more concentrated portfolios, as the number of stocks in the median fund has fall by around 10% over the period.

So, against a combination of lower underlying volatility levels and less thematic risk, managers have sought to maintain their levels of risk, and this has manifested itself in an increase in stock selection risk. ■ ■ ■

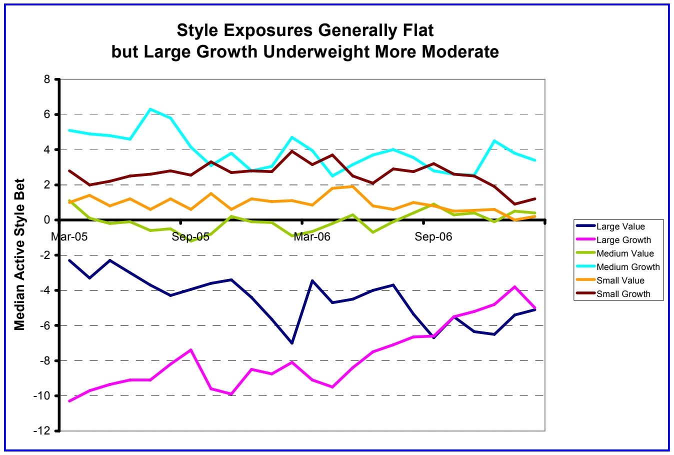

FIGURE 4

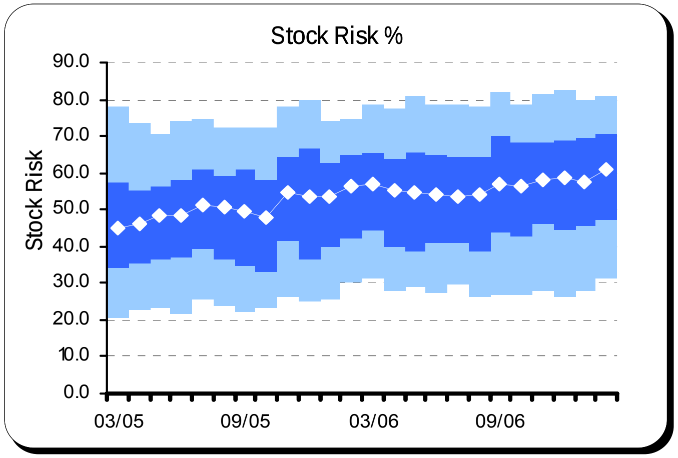

FIGURE 5

Tips and Tricks: New Features

In response to client requests to provide a simple way to load Exchange Traded Funds (ETFs) and Futures, and incorporate them within the Style Research Portfolio Analyzer, we have introduced a new ETF mapping tool. This allows users to define mappings of the SEDOL, CUSIP, ISIN or Ticker codes of ETFs to funds or benchmarks already loaded and available within the Style Research Portfolio Analyzer application.

At load time, ETF codes are recognized and loaded by the system as part of a portfolio. During the analysis of a portfolio, ETF codes are replaced by the actual underlying stocks and the analysis is performed on the complete set of holdings with rebalanced weights.

Clients who subscribe to our built-in Proprietary Benchmarks can additionally benefit from our internal ETF mappings. These are integrated within the Style Research Portfolio Analyzer software and automatically recognize ETFs and link to the licensed Proprietary Benchmark indices. For further information please see the relevant chapters in the Analyzer Help file.

See **Tips and Tricks: Advanced Options** on page 6

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"Style Research aims to provide practical professional investment insights in a way which can be easily used, understood and communicated between investment professionals as well as to clients. Style Research uses objective and comprehensive holdings-based approaches to Style and Risk analysis which reflect the increasing demand for best practices in manager due diligence and increasing fiduciary responsibilities within the investment community."

Tips and Tricks: Advanced Options

What are those advanced options for? For most portfolio analyses the default settings are fine, but there are instances where adjusting the advanced settings can be useful. Here are all the advanced settings and an outline of what they do:

1. DISTRIBUTIONS

Settings: *Market Rel* (Default) or *Benchmark Rel*.
Effect: Determines the universe on which the distributions are based. By default the distribution segments are calculated using the entire market and top 40% means the top 40% of the market. *Benchmark Rel.* will mean that the distribution segments are based on the Benchmark.

Caution: The Benchmark Rel. option should be considered carefully (or avoided) when Style benchmarks are used. Category labels should also always be carefully considered by the user for non-default settings.

2. FUND VALUE (BASE CUR.)

Settings: *Not Specified* or value of the fund in base currency terms.
Effect: If *Not Specified* then the value of the fund is set to US$100 million, or its equivalent in the currency of the analysis, for the liquidity and VaR calculations; otherwise the value entered is used.

3. INCL. ETF/FUND STOCKS

Settings: *Yes* (Default) or *No*.
Effect: ETF/Fund mappings will be replaced by the underlying stocks if set to *Yes,* otherwise ETF mappings are ignored. See *Tips and Tricks: New Features* on page 5.

4. SAMPLE SIZE ADJ.

Settings: *Yes* (Default) or *No*.
Effect: Sample Size Adjustment (SSA) scales the factor tilts based on the distribution of the portfolio holdings weights. SSA allows portfolios of different numbers of stocks to be compared on a fair basis. It may be useful to set to *No* if the tilt analysis is being used to help combine many funds, although it would still be advisable to run the combined fund again with SSA set to *Yes*.

5. SIZE DIST.

Settings: *Percent* (Default) or *Fixed Values*
Effect: If *Percent* then the distribution segments are calculated based on the percent of market capitalization: a setting of 40 in the Size distribution grid would represent 40% of the Market or Benchmark. *Fixed Values* allows the cuts to be based on fixed factor values. So, for example, distributions can be created based on specific market caps or even, say, dividend yields, with user-defined ranges such as 0%–2%, 2%–4%, 4%–6%.

6. TILT CONTRIBUTION

Settings: *Yes* or *No* (Default)
Effect: *Yes* creates an additional worksheet which lists the breakdown of factor Tilts down to the stock level for every stock in the portfolio and benchmark. This can be used to determine which stocks are contributing most to the Style Tilts™.

7. TILT DEFLATOR

Settings: *Market* (Default) or *Benchmark*
Effect: The Tilt Deflator setting defines whether the Benchmark or Market should be considered as the representative universe for the Style Skyline™ calculations. In the tilt calculation the weighted standard deviation of the universe is used to scale the difference between the portfolio and benchmark. In addition, adjustments to factor values for sector, country and country-sector analysis will be based on weighted averages of this universe.
Where broad benchmarks are being used, the Market and Benchmark will be very similar in weighted terms for the purpose of Tilt calculations. Some scenarios where setting Tilt Deflator to *Benchmark* is useful include:

• Analyzing a small company fund against a small company benchmark where the Benchmark is likely to be very different to the Market in weighted terms.

• An Emerging Market portfolio where 1% of the fund is invested in the US. To include all portfolio stocks, the Market Region has to incorporate the US. This has the unwelcome side effect of adding all US stocks to the Market. In this instance it makes sense to set the deflator to *Benchmark*.

Caution: The Benchmark option should be considered carefully (or avoided) when Style benchmarks are used.

8. TILT RAW DATA CALC.

Settings: *Selected Factors* (Default) or *All Factors*
Effect: Tilt Raw Data Calc set to *All Factors* results in the Style Skyline™ data being calculated for all factors in the system (currently 39). The additional data can be found in the Raw Data and the Tilt Contribution worksheets. This facility is useful when the full data set is required for subsequent analysis or uploading into Snail Trails.

9. TILT SCALE MAX/MIN

Settings: *Auto (Default)* or a *number*
Effect: *Auto (Default)* scales the Style Skyline™ charts such that all the bars are clearly represented. Setting a fixed max or min will fix the scale; this can be useful for comparison purposes but risks missing some of the detail.

10. WEIGHT CHARTS

Settings: *Default* or *Long/Short*
Effect: This setting was added for the growing number of 130/30 funds. These funds have long and short positions but are assessed against traditional long only benchmarks. When the weight charts setting is set to *Long/Short* the Sector and Country skylines show the long, short and net positions of the portfolio alongside the benchmark weight and coverage.

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Style Research Awards

First World Citizen Scholarship

We are pleased to announce that the first Style Research World Citizen Scholarship has been awarded to Ms Divya Reddy, of Bangalore, India.

Ms Reddy, a graduate of New York University and The London School of Economics, will begin her programme of study towards the Masters in Business Administration at the London Business School this autumn. Following the MBA, Divya aspires to turn her education, working experiences and business skills towards establishing a non-profit organization introducing and supporting technology and business strategic planning within the Indian farming sector. By putting into place facilities to bridge the digital divide between rich and poor, Divya hopes to raise social welfare and achieve a measure of positive economic transformation, encouraging improving quality, productivity and efficiency within the rural agricultural community. We wish her every success.

The Style Research World Citizen Scholarship was established in 2007 to mark the 10th anniversary of the incorporation of the company. This continuing academic award is intended to support the MBA studies, at the London Business School, of deserving students wishing to use their acquired knowledge and business skills to improve the world around us. ■ ■ ■

Carbon Counts 2007

A recently published report by Trucost, an environmental research company, assesses the carbon footprint of a selection of UK investment funds. With an increasing focus on climate related issues, this is a timely analysis, providing a view of the carbon emissions associated with each fund. We were delighted to help in this effort by the provision of data. See 'Carbon Counts 2007', available from www.Trucost.com, for more details.

Style Research will continue to work alongside Trucost, with the planned introduction of some climate change related factors into the Portfolio Analyzer later this year. ■ ■ ■

THE BUILDERS ARE IN . . .

The London office of Style Research will soon be moving to new premises.

While the move is not without mixed sentiment (the company was founded in Hampstead Village and Style Research has been part of the local community for the past 10 years), the expansion of our European business has necessitated the relocation to larger offices and a more central London address.

Work is, we are assured, well on the way, and we plan to open our new offices on Monday, August 13 at:

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