InvestmentMetrics

Team Dynamics within Global Equity

by InterSec Research

Global markets remain an interesting area within asset management as more and more plans allocate a significant portion of their equity to global products. With that in mind, InterSec is pleased to provide you with our first client memo of 2013 which discusses the differences in team structure and research capabilities within our institutionally competitive global equity universe.

While presenting the 2012 Mid-Year Investment Industry Report, one of the more interesting topics of discussion revolved around team structures and research capabilities of the largest asset gathering global equity managers. Over the years, concerns about global equity have shifted away from asking whether plans hire global managers at all, to identifying who are the best managers, and why. This shift in perception has shown itself clearly as global equity has seen a net gain of over $30 billion since 2007. In a 2010 memo Implementing Global Equity, we mentioned that historical concerns (such as "global reach") were less likely to hinder smaller, single office teams from competing for institutional mandates. Since then, we have focused on unconstrained/benchmark agnostic products as well as low volatility themes as being relevant in the post-2008 world. In our first memo of 2013, we will focus on the asset gathering, risk characteristics and performance of global equity products by their research structures.

To frame this paper, our consultants broke down the broad InterSec Research Global Equity Universe (which consists of 107 institutionally competitive products as of September 2012), by first screening out purely quantitative products, then grouping the remaining products by research location and team structure.

Research Location

Investment research team location was classified into two broad categories; centralized and global / multi office research. Centralized research teams have only one investment office with all research analysts physically in the same building as portfolio managers. This sample contains 54 managers. In order to qualify as a member of the global research category, managers were required to have analysts with boots on the ground in multiple locations (most with locations globally). There are 37 managers in that sample.

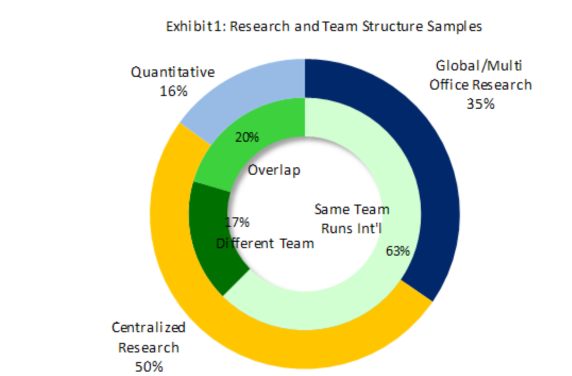

Exhibit 1.

Team Structure

Our consultants then broke down the universe into three categories based on team structure and the products they're responsible for (these samples are not mutually exclusive from the research team samples). Many global equity teams also manage their firms' international equity product, and there are 55 managers in this sample. Of the managers in the Global Equity Universe, 19 have some overlap between the international equity team management and the global equity product management (whether it be head portfolio manager or research analysts), and 14 managers have a separate team managing both global and international equity strategies. We also highlighted firms that do not manage a US or EAFE product; there are 19 firms that manage a global equity product without managing a US product, and there are ten managers who do not manage an international equity product. Exhibit A in the Addendum shows the average excess returns of global equity teams that manage an international product with their global team, with some overlap, and with as a separate team. Typically, the group that manages a global product as a stand alone is the most successful in terms of relative performance.

Funding Trends

During the first half of 2012, seven of the top ten business winners had centralized research capabilities. Two asset gatherers utilized a broad global research structure, and only one quantitative firm made the list. As Exhibit 2 highlights, over the last five years there has been a

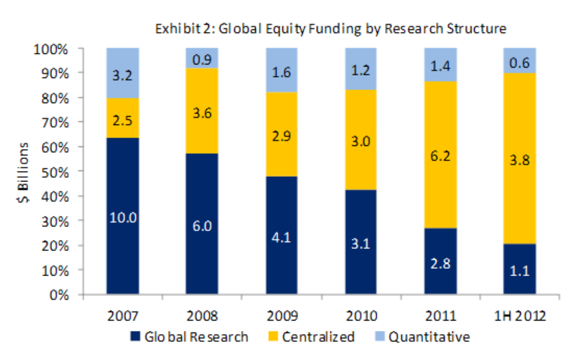

Exhibit 2.

clear and distinct trend as plans have favored products managed by a centralized research teams. Such products captured just over 15% of new funding in 2007, and as mentioned above, today they are wining 70% of new business. In fact, over the last five years the centralized research teams are the only group to have positive net flows in each of the last five years (Addendum Exhibit C).

Performance

Comparing various sub samples at the median level, whether by style, process, orientation or even benchmark awareness, usually provides little from which to draw conclusions. Therefore in Exhibit 3, we focused on the

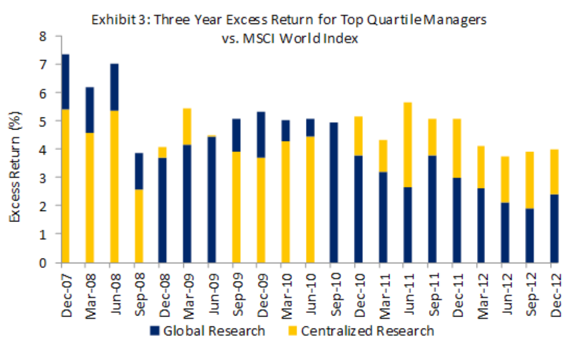

Exhibit 3.

top quartile performers by research team structure. On a rolling three-year basis, managers with centralized research surpassed the performance of their global research counterparts by year-end 2010. There are several reasons for this change in relative performance, but the greatest is due to centralized teams being able to protect extremely well during down markets as shown in Exhibit 4 (Exhibit D in the addendum also shows that some of the better performing centralized research teams

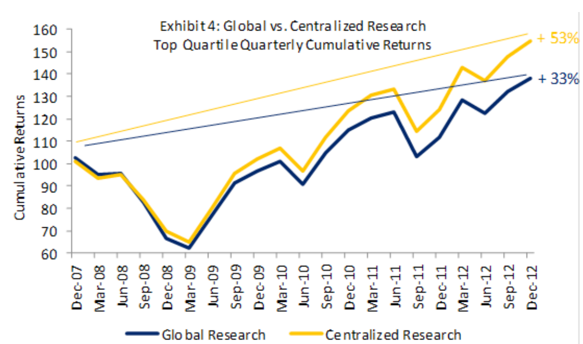

Exhibit 4.

have lower standard deviations over the last three years). Exhibit 4 compares the draw down results for the top quartile manager over the trailing five years. Centralized research teams lost 53%, followed by a bounce back of 138%, resulting in an overall gain of 53%. Globalized research teams on the other hand, contracted over 60%, only to bounce back 121%, leading to an overall gain of less than 35%. The stop loss and subsequent bounce back that centralized teams were able to implement enabled them to add more value on a cumulative level over the full five year time period in question.

In Exhibit 5, we plotted the up and down market performance quartile rank by research team structure. Interestingly, when we overlay the top new business winners (in green) over the last five years, we see

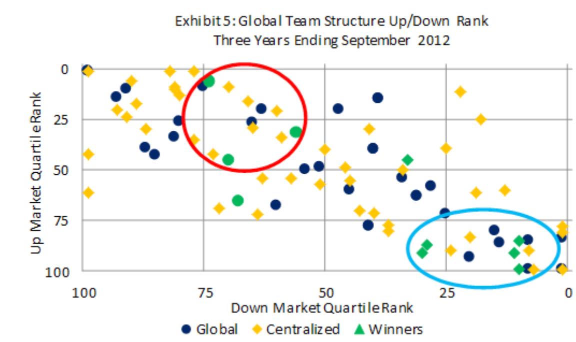

Exhibit 5.

a distinction. The most successful asset gathering managers with global research platforms performed better in up markets and are located in the upper left had side or the chart (circled in red), while the centralized research winning teams tended to perform better in down markets and are group in the lower right quadrant (circled in blue).

Furthermore, a manager is more likely to manage a product with fewer constraints if they work at a centralized research office. Exhibit E in the addendum analyzes the global equity universe based on the ownership structure of the firm and found that most agnostic products tend to be run by employee owned, privately held firms. Furthermore, those same managers tended to have the highest excess return over a three-year time period. Only a handful of agnostic products are run by bank owned management teams, but they too have high excess returns. As we have noted before, regardless of ownership or research team structure, those products with the least constraints have the strongest performance through the recent market volatility and are wining the lion share of the new mandates.

While thus far we have focused on the abilities of the centralized research teams, attribution results in Exhibit 6 point out that global research teams do offer strong stock selection. At the median level, stock selection was higher for global research teams for all of the calendar years 2008 through 2011.

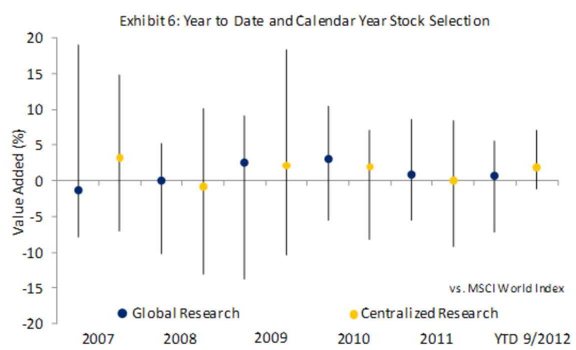

Exhibit 6.

Conclusion

The funding trend within global equity over the last five years has been on a steady increase towards centralized research teams. This has coincided with turbulent markets, and a struggling economy.

Since January 1970, there have been eight time periods during which the MSCI World Index has dropped in consecutive quarters; five of which have just been two quarters in a row. There were three periods however, when the losses spanned a longer time period; four quarters from Q4 1973 through Q3 1974, four quarters from Q2 2000 through Q1 2001, and the most recent being within the last five years. The MSCI World Index dropped for six consecutive quarters from Q4 2007 through Q1 2009. This most recent drop in world equity markets caused some investors to reconsider their risk appetites, and subsequently reallocate to new products that would help mitigate losses. Centralized research teams benefitted the most from this shift because products which are managed by one team, in one location, have protected very well through down markets; generally with less volatility. In recent discussions with clients, we have also mentioned that some plans have adopted a global opportunistic allocation to introduce new ideas into their portfolios. This has led to a grey area between traditional fully invested long-only equity products, and more total return focused products that include cash, commodities, convertibles, and hedged position. These products tend to be housed within employee owned, privately held companies. Our conclusion is that while funding activity in the recent past has favored centralized teams, performance is not necessarily dictated by team structures or firm ownership.

Addendum

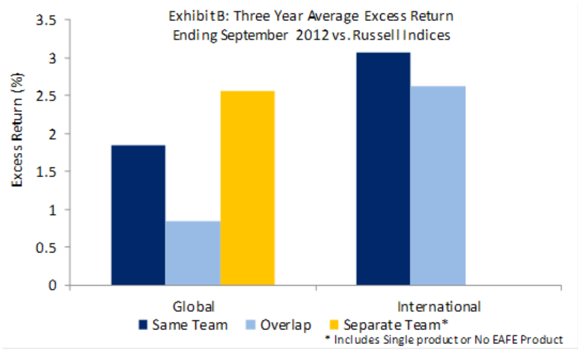

Exhibit A.

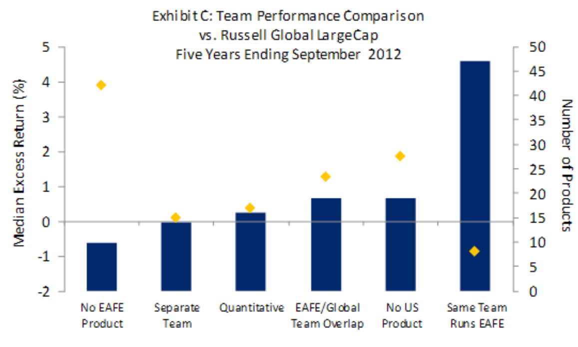

Exhibit B.

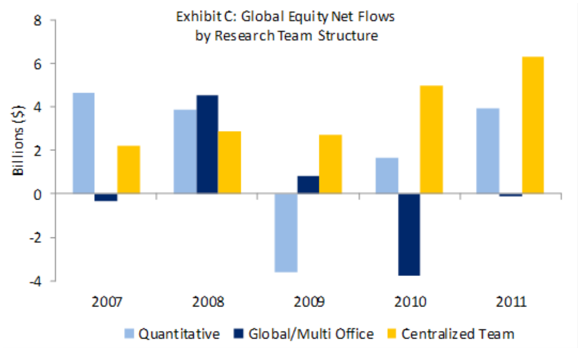

Exhibit C.

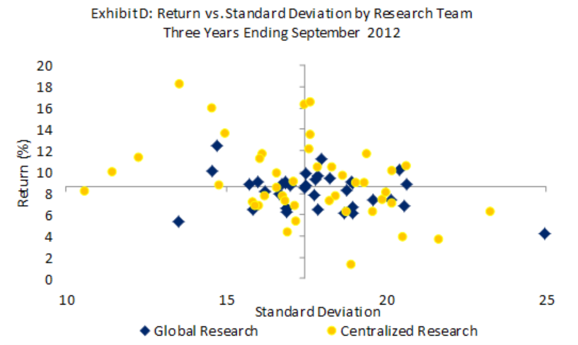

Exhibit D.

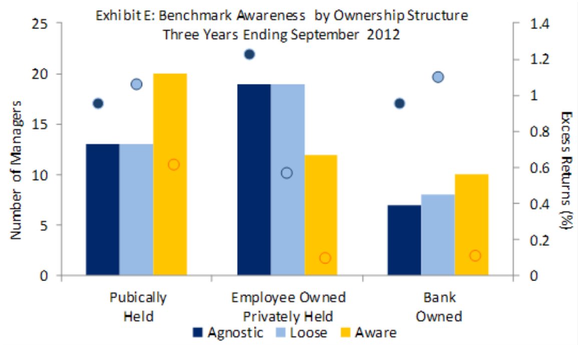

Exhibit E.

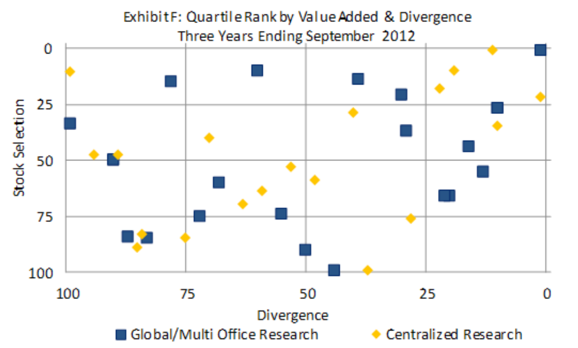

Exhibit F.

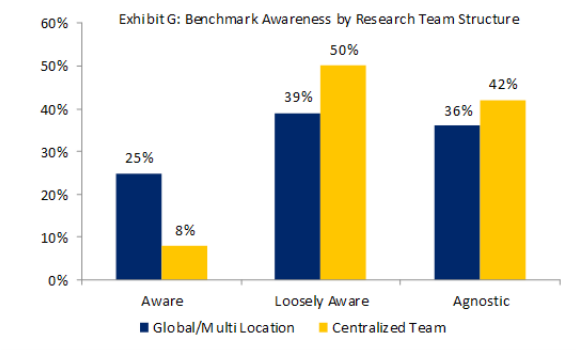

Exhibit G.

Based in Darien, Connecticut, Investment Metrics is an independent provider of investment performance analytics, manager research, reporting and data solutions for investment consultants, wealth advisors, asset managers and investors.

For more information, please visit our website at invmetrics.com.

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