InvestmentMetrics

Benchmark Agnostic Products in the Global Equity Landscape

by InterSec Research

A supplement to Implementing Global Equity, this piece takes a deeper look at benchmark awareness, primarily focusing on the successes of unconstrained/benchmark agnostic global equity managers.

As markets became more global in nature over the last decade, the case has been made by several leading consultants for U.S. pensions plans to move from the traditionally segregated U.S. and non-U.S. equity approach to a more integrated global structure. Prior to 2003, global equity had long been ignored, today it's one of the few growing mandates on a net flow basis. The last three years global has gained 35-50% of traditional international equity funding. During the last seven years as global equity investing started gaining momentum, benchmark agnostic products (products which have had little concern in replicating index allocations and performance) have played an ever growing role within the allocation. In 2003, agnostic products were garnering slightly more than 5% of new funding, since then their market share has increased dramatically, more recently accounting for 25-40% of the new business. (Exhibit 1) Perhaps a bit surprising, these products represent 34% of U.S. tax exempt global equity assets as of December 2009. (Exhibit 2)

To further examine the appeal of these products, we have broken the InterSec Global Equity universe into three sub groups: benchmark aware, loosely aware and agnostic. In this memo, we examine the benchmark agnostic products specifically, focusing on the last three years, comparing their performance and attribution to provide greater insight into current and future appetite for these strategies.

"Benchmark Aware" products are managed with regards to country/regional/sector weights and typically have a targeted tracking error compared to the MSCI World benchmark. "Loosely Aware" products have broader country/regional/sector restrictions, will have greater Emerging Markets exposure, but still manage risk conscious of the index. "Benchmark Agnostic" products will have little to no constraints with regard to exposures by country/region/sector and Emerging Markets. Agnostics are typically fundamental and bottom up with regards to process and some will have exposures to hard commodities such as gold, investments in non-equity holdings including some high cash allocations.

(All Asset and Funding data in this paper based on InterSec's bi-annual AUM Surveys.)

Strong Returns & Risk Adjusted Performance

As we have noted previously in our bi-annual industry research reports, at the median level, global equity products have not fared particularly well when compared to a U.S./EAFE capitalization or evenly weighted blend. Over the last three years the median benchmark aware product outperformed the MSCI World benchmark by 40 basis points, compared to 50 basis points for the loosely aware median. The agnostics, however, have fared much better through those turbulent markets, outperforming the MSCI World index by 3.7% at the median level. As the scatter chart (addendum exhibit A) demonstrates, as constraints have been loosened, the agnostic pool of managers has taken on more risk than their peers with regards to tracking error, and have subsequently delivered stronger returns on both an absolute and risk adjusted basis. There is a strong group of agnostics in the upper right quadrant of the scatter chart with

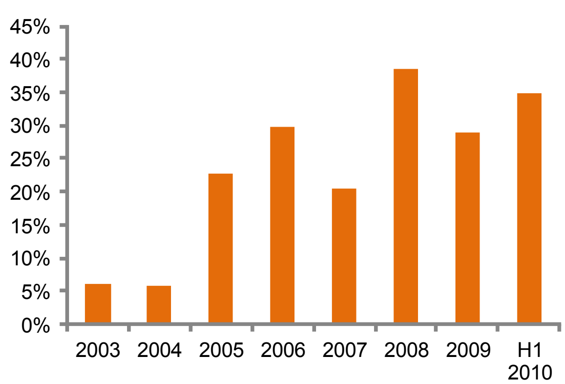


Exhibit 1.

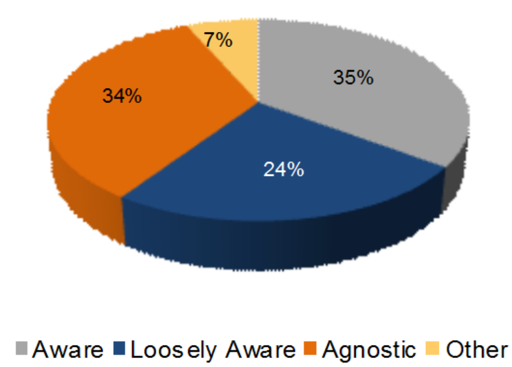


Exhibit 2.

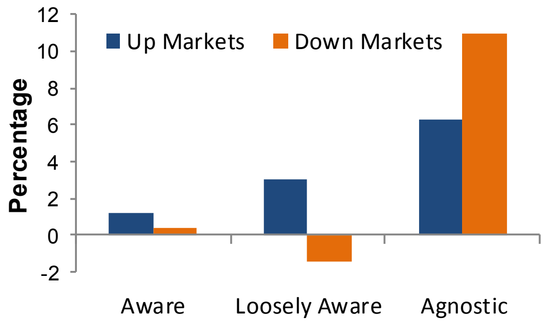


Exhibit 3.

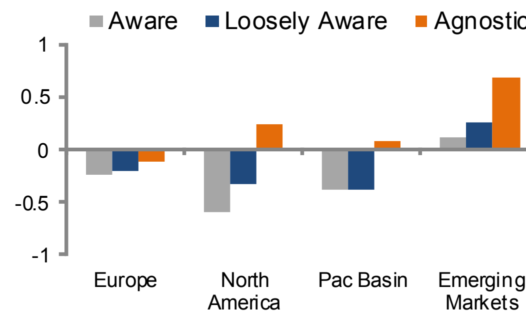


Exhibit 4.

tracking error ranges of 5-10 and excess returns 4-14%. The information ratios delivered by these products range from .7 to 1.7 for the last three years. These products are also among the top asset gatherers of global equity mandates. (exhibit 7)

Recently there has been added emphasis in the industry on finding ways to separate alpha and beta, one way of doing so is looking at consistency of performance through various market conditions. During the last three years, benchmark aware, loosely aware, and agnostic managers have all added value in up markets, but the agnostics have demonstrated a greater ability to limit catastrophe in down markets. As Exhibit 3 demonstrates, in up markets the last three years, benchmark aware and loosely aware products have added 1.2% and 3.0% respectively, while agnostics have added 6.3%. In down markets the benchmark aware products have added 0.4% while the loosely aware underperformed by 1.4% compared to the agnostics which have added 11.0%. This ability to add value no matter what the market conditions are another distinguishing characteristic of the agnostic products—the ability to avoid style traps.

Market & Attribution Results

During the last three years, global equity managers have struggled to add value via stock selection in developed markets, particularly within the United States. Therefore, we typically find that the median global equity manager is underweight in allocations towards the U.S. and generates most of its alpha from emerging market names. Exhibit 4 clearly demonstrates that the more benchmark aware products have failed to add value in developed markets while the agnostics have had better success in all regions whether developed or emerging markets.

As equity markets began to sour at the end of 2007, loosely aware products fled to the safety of developed markets, especially the U.S., and in doing so took on more of a benchmark profile. (Exhibit 5) This flight to safety proved to be costly as the U.S. was a detractor of performance for both the aware and loosely aware groups. The agnostics, on the other hand, maintained their high conviction bets, while not intentionally making a U.S./non-U.S. distinction, resulting in a dramatic relative underweight to the world's largest market. This served to further differentiated them from both the index as well as their peers. Despite this relative underweight, agnostics were able to pick the right stocks in the U.S., the market has been a positive contributor to the groups performance—besting the aware, and loosely aware groups by more than 1% at the median level during the three years ending September 2010.

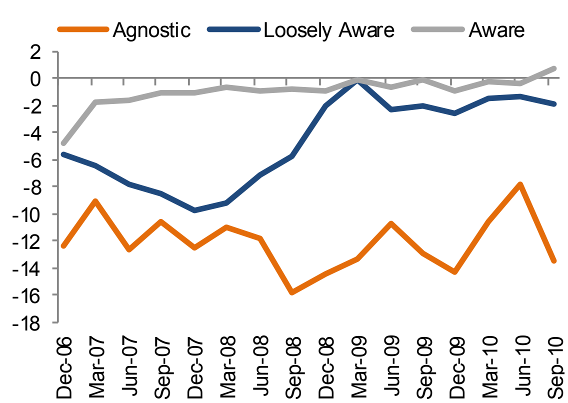


Exhibit 5.

Exhibit C in the addendum also highlights the agnostics greater ability to add value through stocks selection.

Top New Business Winners

Examining the characteristics of the top benchmark agnostic new business winners the last three and half years a few common threads run through all the managers; every product listed is fundamental with regards to orientation, all are purely bottom up stock pickers by process, and 7 have a designated Value or Growth style tilt. Half of these products are concentrated by holdings ranging from 35-60 names, the average for the full group being 115. Half of these managers are located in the U.S. and half are located outside the U.S., predominantly in the U.K. where there has been greater institutional interest not only in global equity but the benchmark agnostic products specifically.

Conclusions

The last few years we have witnessed the strong momentum toward global Equity investments from U.S. plan sponsors. One of the benefits of adopting the global equity allocation is the ability to hire unconstrained benchmark agnostic managers that seek out the best companies for their portfolios regardless of borders or industries. These managers tend be fundamental, all cap, stock pickers who have distinguished themselves from their peers by adding value through stock selection in both up and down markets through the turbulent markets the last three years.

Exhibit 7: Top ten benchmark agnostic new business winners 2007 –1H 2010

Initial Funding 2007 - 1H 2010	Ind?	Style	Process	Orientation	Capitalization	Typical # of Holdings	Preferred Benchmark	3Y Return Rank	3Y I.R. Rank
$ 1,916.80	No	Growth	BU	Fundamental	Large Cap	130	MSCI ACWI	STR	STR
$ 1,806.30	Yes	Growth	BU	Fundamental	All Cap	35	MSCI ACWI	1	1
$ 1,403.70	No	Value	BU	Fundamental	All Cap	110	MSCI ACWI	3	3
$ 1,017.60	Yes	Core	Blend	Fundamental	Large/Mid	60	MSCI World	2	2
$ 813.00	Yes	Value	BU	Fundamental	All Cap	130	MSCI ACWI	STR	STR
$ 600.00	Yes	Core	BU	Fundamental	All Cap	60	MSCI World	2	1
$ 558.48	No	Growth	BU	Fundamental	All Cap	40	MSCI World	4	4
$ 532.00	Yes	Core	BU	Fundamental	All Cap	450	MSCI World	1	1
$ 346.10	No	Value	BU	Fundamental	All Cap	85	MSCI ACWI	1	1
$ 152.00	No	Growth	BU	Fundamental	All Cap	50	MSCI World	1	1

* Return and Information Ratio quartile rank based on 3 year performance periods ending September 2010 vs. MSCI ACWI index
* Independent is defined as privately held or greater than 50% employee ownership
* STR refers to a short track record, less than three years

Addendum

Exhibit A: Global equity universe excess return / tracking error scatter

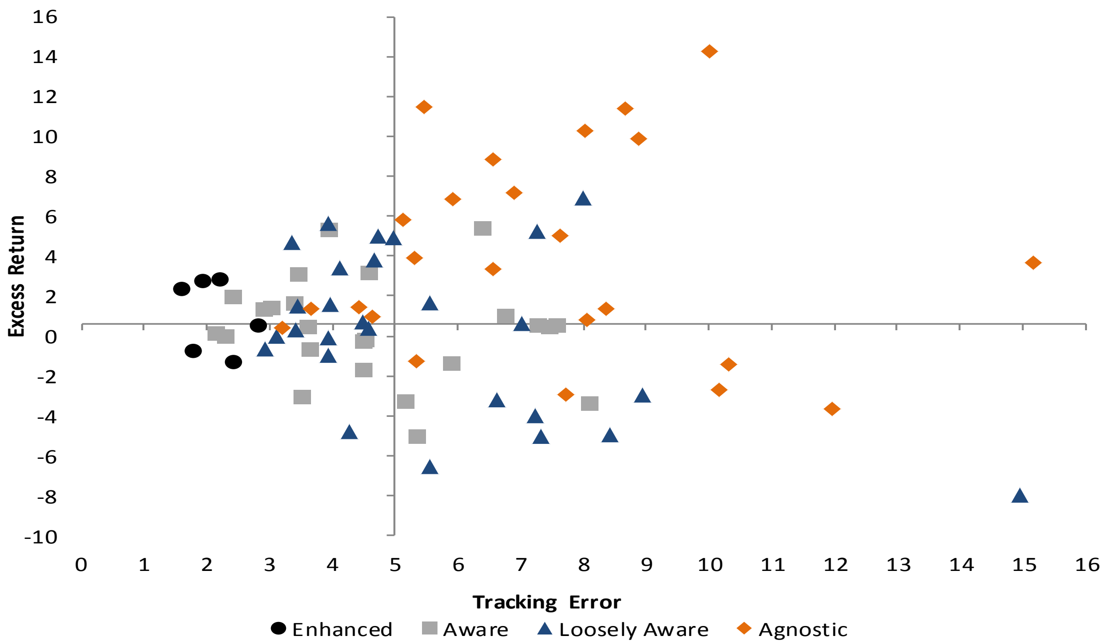
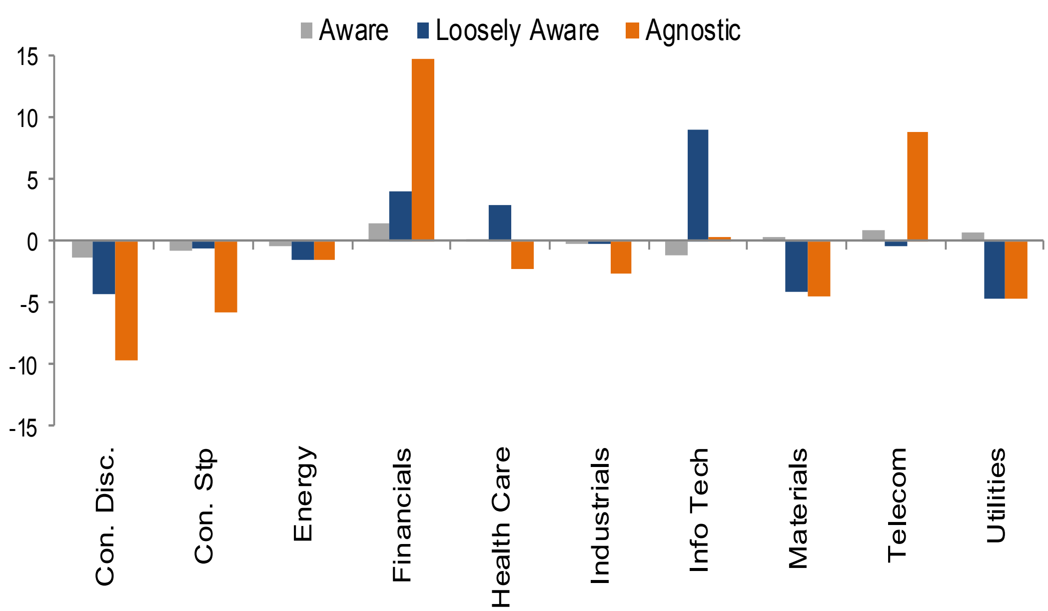
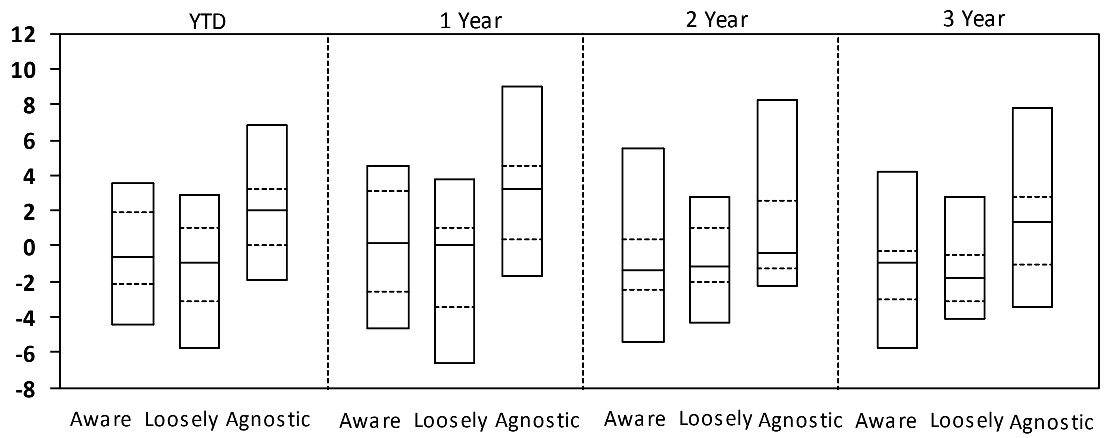


Exhibit B: Average active global equity sector weights — one year ending September 2010



Addendum

Exhibit C: Global equity stock selection — periods ending September 2010



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