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**2007: A Challenging Environment**

**December 31, 2007**

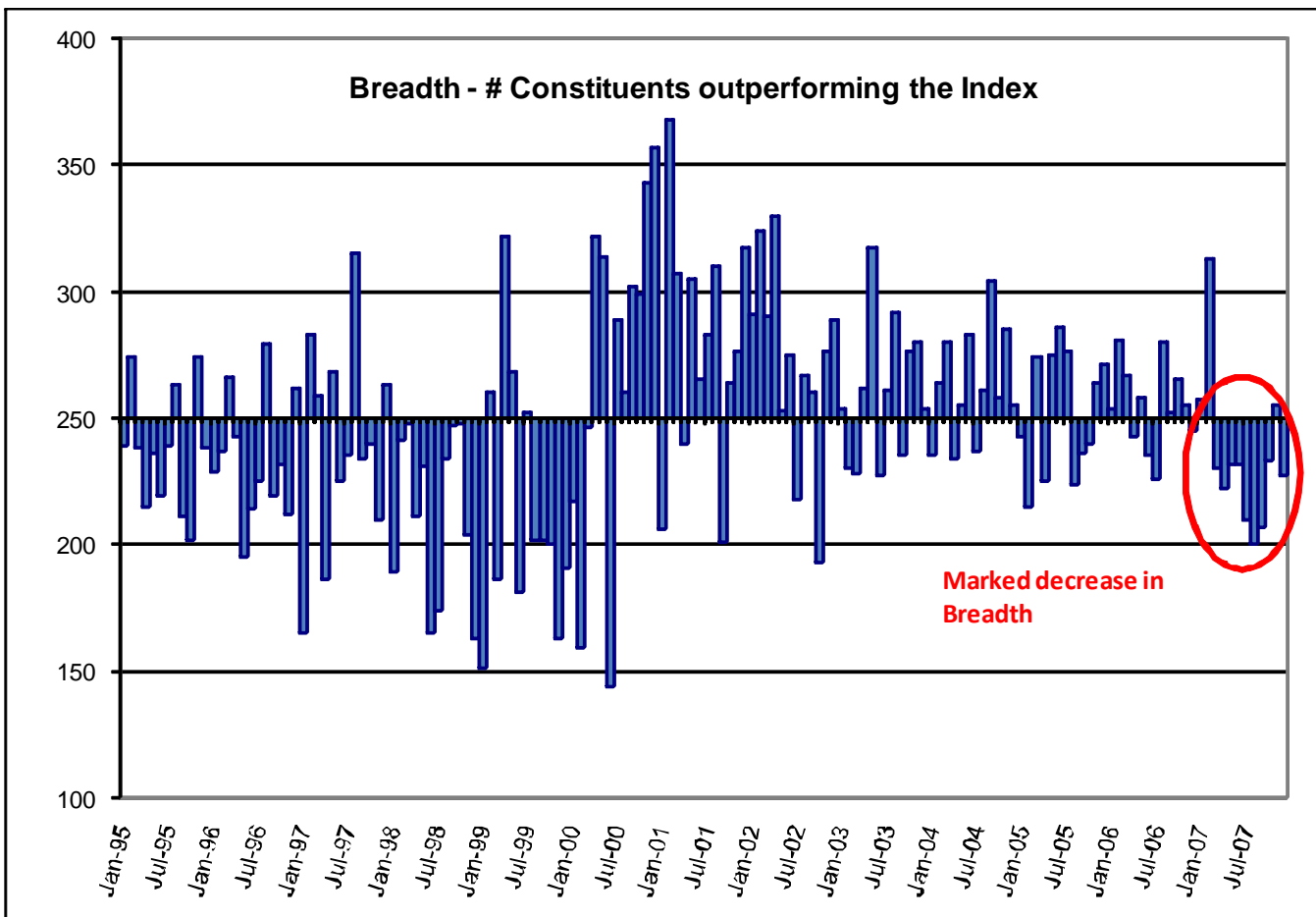
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## 12/31/2007 LargeCap Update

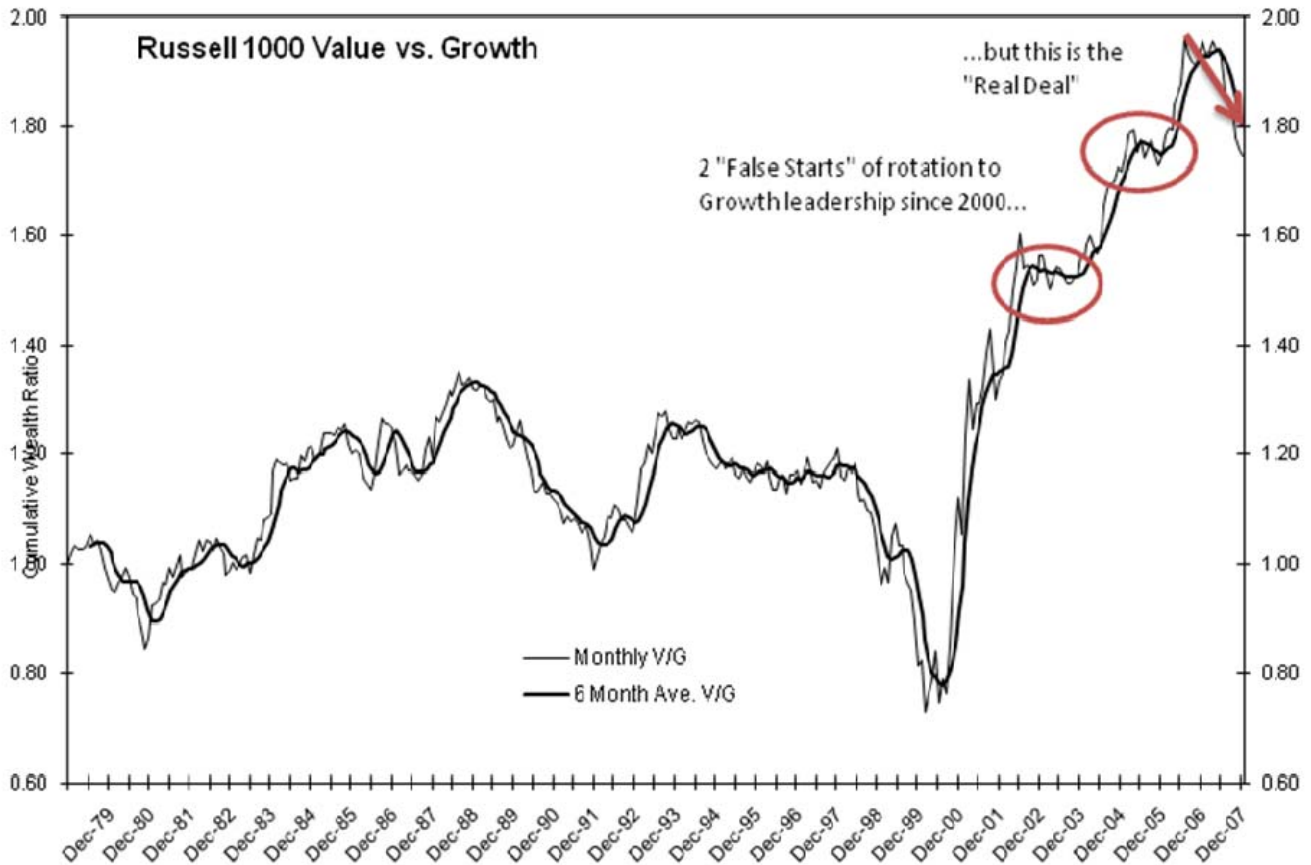
### LargeCap performance:

2007 has proven a difficult year for quantitative strategies in general, and the AIP LargeCap strategy has not been an exception to that rule. We have faced 3 main headwinds this year: a decrease in market breadth (as measured by the number of index constituents outperforming the S&P 500), a style rotation from smaller-capitalization value stock market leadership to mega-cap growth stock leadership, and perhaps most significantly (and certainly most unusually) abnormal factor returns due to heavy liquidations and deleveraging by quantitative long/short hedge funds.

Market breadth tends to ebb and flow, often in conjunction with style rotation. As the broad stock market tumbled from its 2000 peak, market leadership broadened considerably. On occasion, over 70% of the members of the S&P 500 outperformed the Index. This type of breadth serves active managers well, making picking "winners" relatively easier than would be the case in a narrow market. As recently as February, over 60% of the S&P 500 constituents beat the market. However, in the following seven months, less than 220 stocks topped the index in an average month. This became a more difficult environment for active managers in general.



Inflection points in the market (i.e. changes in market leadership) are typically the most difficult environment for our modeling process. Our dynamic and adaptive models are built to detect enduring changes in leadership, rather than reacting too quickly to short-term interruptions in market leadership. We've had a couple of "false starts" in the style/cap rotation since 2000, yet neither proved enduring. This rotation appears to be both significant and enduring. So, while we'd expect a short-term period of underperformance, we also see that our models and portfolios have been adapting to the changed environment, and our LargeCap clients are now positioned to benefit from a continuation of mega-cap growth outperformance.



The final element of this perfect storm, if you will, has been behavior driven by hedge funds. Many hedge funds bet on convergence of yield spreads across different credit markets. As spreads widen, hedge funds often "double-down (or triple or quintuple down)", betting on a return to normal spreads. As the housing market worsened and sub-prime mortgages began suffering defaults, doubling down did not work (and in fact led to continued losses), and in fact funds had to start to cover their bets, in some cases to meet redemption requirements. To raise money, many of these funds (multi-strat funds, or funds that had bets in multiple markets) went to the most liquid market (the US equity market) and began raising cash by covering short positions and selling long positions. Knowing that most quant investors have models largely based on valuation and quality factors (i.e. shorting high P/E stocks and high P/B stocks, while going long low P/E and low P/B stocks), we see that covering shorts puts buying pressure on high P/E stocks and high P/B stocks, and selling longs positions puts pressure on low P/E stocks and low P/B stocks. The returns to these factors were highly correlated (nowhere to hide), and the magnitude of this perverse behavior was enormous from late June through early August. This period, in fact, accounts for all of our underperformance in 2007.

## LargeCap YtD Performance Attribution:

As discussed above, we see that active exposure to the Barra Risk indices was the primary drag on year-to-date active performance through December 31, detracting 1.21% from active return. Stock selection was not among the larger detractors, but did subtract 0.33% from active return.

### EXECUTIVE SUMMARY - Cumulative Contribution to Active Return

Source of Return	Full Timespan			
	Contribution(%)	Risk(% sd)	IR	T-Stat
1 Expected Active	-0.07	N/A	N/A	N/A
2 Market Timing	-0.24	0.25	-1.01	-1.01
<b>3 Risk Indices</b>	<b>-1.21</b>	<b>0.79</b>	<b>-1.48</b>	<b>-1.48</b>
4 Industries	-0.38	1.19	-0.29	-0.29
5 Asset Selection	-0.33	2.31	-0.09	-0.09
6 Trading	N/A	N/A	N/A	N/A
7 Transaction Cost	0.00	N/A	N/A	N/A
8 Total Exceptional Active[2+...+7]	-2.15	2.76	-0.72	-0.72
9 Total Active [1+8]	-2.23	2.76	-0.75	-0.74

Best Five Policies	Average Active Exposure	Risk (% Std Dev)	Contribution (% Return)		
			Average	Variation	Total
Momentum	0.15	0.54	0.88	-0.01	0.88
Banks	-0.02	0.16	0.35	0.16	0.51
Oil Refining	0.02	0.18	0.23	0.09	0.32
Oil Services	0.01	0.65	0.41	-0.12	0.29
Size	-0.16	0.28	0.21	0.02	0.24

Worst Five Policies	Average Active Exposure	Risk (% Std Dev)	Contribution (% Return)		
			Average	Variation	Total
Leverage	0.16	0.21	-1.10	0.20	-0.90
Trading Activity	0.10	0.15	-0.39	-0.36	-0.75
Financial Services	0.01	0.14	-0.28	-0.09	-0.37
Earnings Yield	0.01	0.29	-0.02	-0.34	-0.37
Defense & Aerospace	-0.02	0.19	-0.33	-0.02	-0.35

Turning to the individual Barra Risk Indices, we note statistically significant poor performance from our exposure to the Value, Trading Activity, and Leverage factors. Momentum has been a strong positive contributor year to date.

At the turn of the year, the portfolio had a strong exposure to Value. However, as discussed above, our models and portfolios have adapted to the growth market, and we now carry a positive exposure to Growth. The poor return associated with Trading Activity can be traced to the hedge fund liquidation activity (selling the most liquid assets).

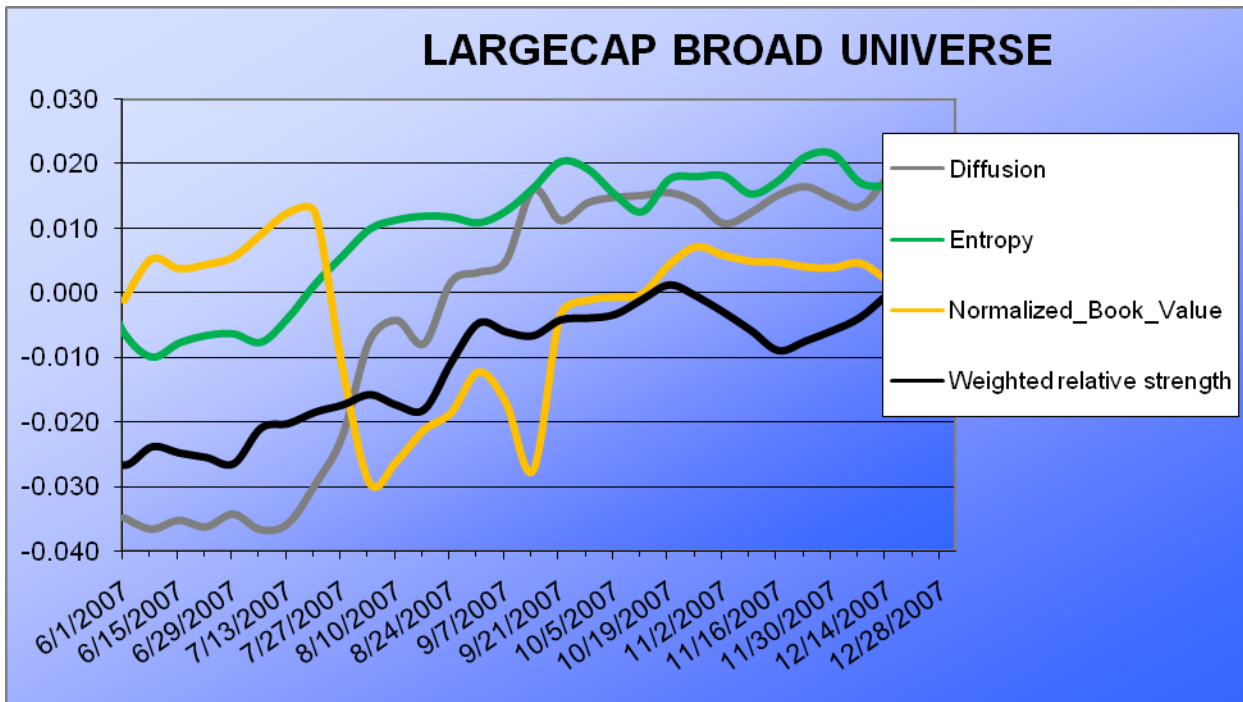
Finally, I'd point out that we trimmed our maximum allowable exposure to these risk factors to +/- 0.15, from our typical +/-0.20. We will return to the typically guidelines as factor return fall back into their typical volatility range. Individual factor returns are as follows:

#### Cumulative Contributions To Risk Index Return

Source of Return	Average Active Exposure	Contribution (% Return)			Total		
		Average [1]	Variation [2]	Total [1+2]	Risk (% Std Dev)	Info Ratio	T-Stat
<b>MOMENTUM</b>	0.15	0.88	-0.01	0.88	0.54	1.63	1.62
<b>SIZE</b>	-0.16	0.21	0.02	0.24	0.28	0.78	0.78
<b>YIELD</b>	-0.03	0.10	0.02	0.12	0.08	1.43	1.43
<b>GROWTH</b>	0.03	0.00	0.03	0.03	0.14	0.21	0.20
<b>NON-EST UNIVERSE</b>	0.00	0.01	0.01	0.02	0.04	0.45	0.45
<b>VOLATILITY</b>	0.01	-0.04	0.05	0.01	0.08	0.09	0.09
<b>CURRENCY SENSITIVITY</b>	0.06	0.02	-0.04	-0.02	0.10	-0.20	-0.20
<b>SIZE NON-LINEARITY</b>	-0.01	-0.02	-0.01	-0.04	0.03	-1.18	-1.18
<b>EARNINGS VARIATION</b>	0.14	-0.16	0.01	-0.15	0.20	-0.76	-0.76
<b>VALUE</b>	0.07	-0.41	0.13	-0.28	0.14	-2.03	-2.03
<b>EARNINGS YIELD</b>	0.01	-0.02	-0.34	-0.37	0.29	-1.19	-1.18
<b>TRADING ACTIVITY</b>	0.10	-0.39	-0.36	-0.75	0.15	-5.13	-5.12
<b>LEVERAGE</b>	0.16	-1.10	0.20	-0.90	0.21	-4.16	-4.15
<b>Total</b>				-1.21	0.79	-1.48	-1.48

## LargeCap: Representative Factor/Model Behavior:

AIP's models are dynamic and adaptive. As such, we'd expect the importance of individual factors to change in response to what is driving excess returns in the market. Below, I show a representative sample of factor weights in our LargeCap model. Some highlights:



**Entropy:** This is a proxy for size. As you can see, entropy's weight steadily increases, which means that larger-cap stocks are increasingly favored by our model.

**Normalized Book Value:** This is a proxy for Book/Price. You'll notice this factor's weight decrease rapidly during July and early August. As discussed above, Book/Price began working inversely during this period because of the hedge fund liquidations.

**Diffusion:** As the market rotates to favor Growth stocks, factors such as diffusion (a ratio of analysts upgrading a stock to analysts downgrading a stock) become very effective. Note Diffusion's importance increasing throughout this period

**Weighted Relative Strength:** A proxy for long-term price momentum, this factor's importance increased along with the duration of the change in style leadership.

## Looking Ahead to 2008:

We've seen evidence of improved performance since mid-August. Given a convincing rotation into mega-cap growth and dynamic models which have ultimately positioned the LargeCap portfolio to benefit from continued mega-cap growth leadership, we expect to have a successful calendar 2008. Hedge fund behavior appears to have normalized to a large degree, and an increase in cross-sectional volatility/dispersion should allow us to return to typical active risk levels, and should make for a better stock selection environment.

