



ADVANCED INVESTMENT PARTNERS

100 Main Street Suite 301
Safety Harbor, FL 34695

TEL (727) 799-3671 (888) 248-8324 FAX (727) 799-1232

a case for: AllCap Core



a case for: All-Cap Core

A Risk-Controlled Equity Portfolio Solution

Many believe that asset allocation decisions are the key determinants of portfolio volatility and performance. But determining the appropriate mix of asset classes is only the first step to building an optimized portfolio. Figuring out how to best manage the asset allocation mix is perhaps a more challenging task. Deciding which market capitalization ranges to utilize, as well as determining which style to employ, is not easy.

Every investor knows that markets cycle over time. A market cap/style that performs well this year may not in the next. These cycles of performance are unpredictable, making timing the market a risk-laden undertaking—and rarely a successful one. By building a single, broad portfolio that covers all market caps and styles at all times, investors can pursue better downside protection against short term underperformance risks, while potentially taking advantage of the highest-performers during any given time period, to enable the equity returns they seek over long investment horizons.

Allocating Assets Effectively

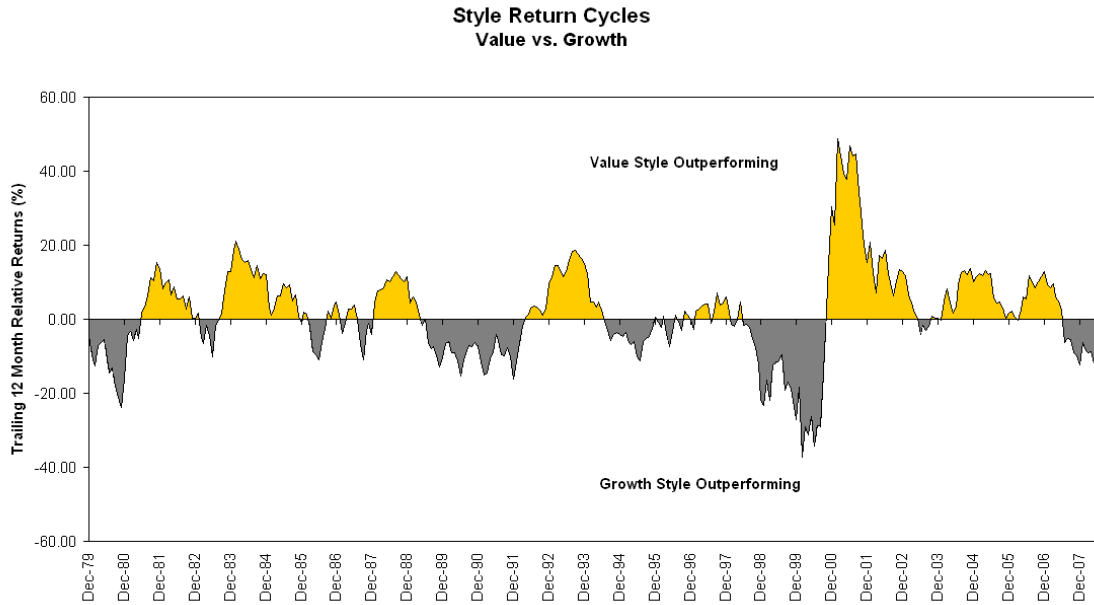
One of the first things any investor does when building a portfolio is to carefully evaluate the market environment in order to determine how best to achieve the highest possible returns given an acceptable level of risk. Essentially, the key question investors ask themselves is: “How can I optimally balance the risk/reward tradeoff?” The answer: effective asset allocation.

The asset allocation decision may be the most important decision an investor makes. According to a popular 1991 study by Gary Brinson, Randolph Hood and Gilbert Beebower, asset allocation accounts for 93 percent of a portfolio’s performance.¹ In developing an asset allocation strategy, investors initially determine the appropriate mix of asset classes: stocks, bonds, cash, real estate, etc.

Subsequent allocation decisions are usually made along two dimensions (1) market capitalization and (2) style. Different asset classes and market-cap/style segments react differently under varying market conditions. Every asset class has an associated level of risk and return expectation. Likewise, every investor has a certain risk tolerance or “risk budget”. It is the challenge of the investor to allocate this risk budget in such a way as to maximize the efficiency and performance of the portfolio.

Understand Performance Cycles

Every investor knows that markets cycle up and down. Styles are constantly rotating in and out of favor. When we look at the performance of growth versus value styles since 1979, as in Figure 1, we see large fluctuations in performance between the two styles. From 1999-2000, when the tech market was flourishing, growth outperformed value. Then, when the tech bubble burst and investors grew fearful, value outperformed growth.

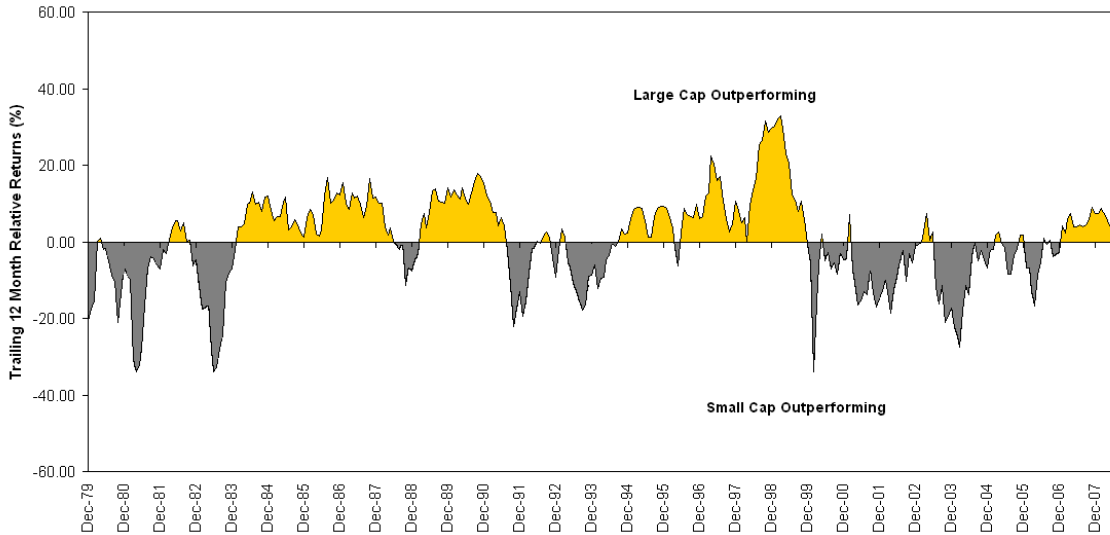


Source: Frank Russell Company. Derived from returns for the Russell 3000 Value and Russell 3000 Growth Indices.

Just as styles move in and out of favor, so too do market cap preferences. Again, historically, when we look at the performance of different market cap preferences since 1979, we see that there are times when large-cap stocks clearly outperform small-cap and vice-versa. While clearly evident with the benefit of hindsight, these dynamic market cycles are still extremely unpredictable. Picking which market cap or style will outperform in the future is a difficult task.



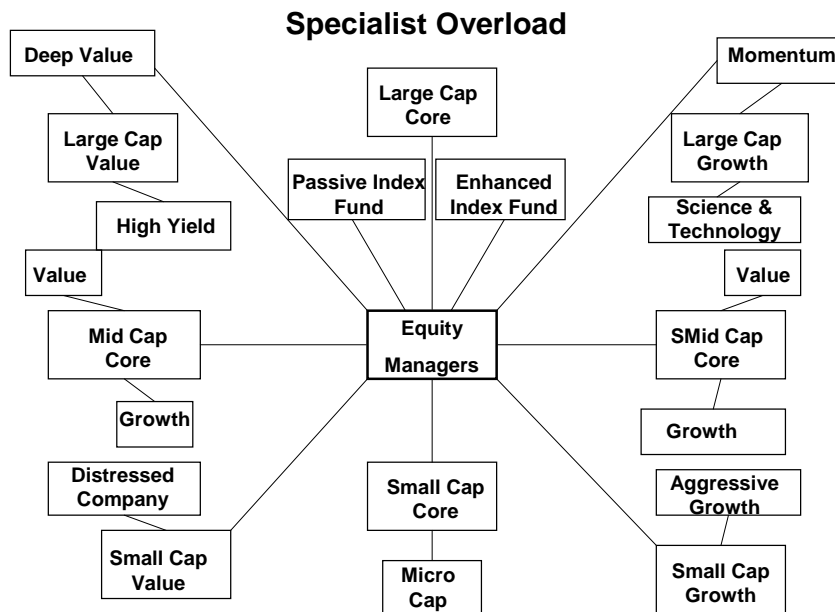
Capitalization Return Cycles Large Cap vs. Small Cap



Source: Frank Russell Company. Derived from returns for the Russell 1000 and Russell 2000 Indices.

To further illustrate the volatility of market cap/style returns, we need only look at the annual performance of each investment cap/style combination from 1995-2007. We can divide the broad U.S. equity marketplace into six market cap/style segments: large-cap growth, mid-cap growth, small-cap growth, large-cap value, mid-cap value, and small-cap value.

When we evaluate the yearly performance of each market cap/style segment over a decade, we clearly see how rapidly different cap ranges and styles move in and out of favor. A deeper analysis reveals that not only was performance extremely volatile year over year, but that the average yearly return difference between the lowest and highest performing cap/style combination was over 26 percent—a very significant spread.



Challenges of the Multiple-Specialist Architecture

While investors have made an intuitively logical step in employing a multiple specialist approach, we believe there are many potential problems that can arise as a result of this complex use of specialist managers.

► Complex Portfolio Positioning

A multiple-specialist approach potentially can result in a very complex portfolio positioning. This approach demands that an investor not only choose the right market cap and style mix, but hire the right manager for each market cap/style segment as well. Choosing the right managers is a tremendous challenge—one that grows greater with increasing levels of specialization.

► Difficulty in Hiring & Monitoring Best-fit Managers

Even if investors are confident in their ability to choose the best-fit managers, can they predict how those managers will perform together and within different market environments? Monitoring the performance of multiple specialist managers is an arduous, time-consuming task. The inherent challenges in doing so make it extremely difficult for the investor, without the proper tools, to develop a true aggregate view of how the portfolio is performing. Distinguishing, for example, where there might be an overweight in value or growth becomes prohibitively difficult.

► Challenging Implementation

There are implicit implementation challenges with a multi-specialist approach as well. The need to rebalance is critical in employing such a complex strategy; but,



too often, it simply does not happen. Investors are too easily swayed by their emotions and it is very difficult for investors to understand the rationale of moving money away from a hot-performing style/cap segment to an underperforming style/cap segment.

► **Increased Costs & Price Inefficiencies**

The multiple specialist manager architecture also can lead to increased costs and inefficient pricing. According to a Frank Russell study, commissions, custodial charges, and taxes and fees account for only twenty percent of all trading costs—the larger percentage of costs are hidden costs resulting from market impact and spreads.¹

As a result of the need to frequently rebalance between cap and style ranges, a portfolio could incur additional transaction costs. This approach could also enhance the probability of unnecessarily paying twice and sometimes three times to purchase the same stock. For example, a small-cap manager could sell a stock that has grown in size only to have a large-cap manager buy back the same stock. Additionally, allocating piecemeal investment dollars to multiple managers cannot achieve the same pricing benefits as can a larger allocation made to a single manager.

When a multi-manager approach fails to achieve the performance results anticipated, investors grow frustrated. How, then, can investors diversify their portfolios to meet performance goals and avoid the complexities and inefficiencies of the multi-manager model?

Diversifying with a Single All-Cap Portfolio

A benchmark-aware all-cap portfolio potentially offers investors a broad, simple solution to meet their diversification goals in a cost-efficient, risk-controlled manner.

Benefits of an All-Cap Portfolio

A single portfolio solution which seeks to closely mirror the broad U.S. equity market in holding all market cap ranges and styles—and that specifically targets the most attractive stocks within each market of those segments—could provide key advantages over the multiple specialist model.

► **Simplicity**

Managing and monitoring an all-cap portfolio is much easier relative to multi-manager portfolios. The simplicity of a single portfolio enhances the ability of advisers and clients to develop a clear picture of how the portfolio is performing.

¹ Werner, Robert “Measuring Transaction Costs”, Frank Russell Securities, Inc. *AIMR* 2001.



This simple portfolio structure potentially eliminates the securities overlap that can sometimes take place within the multiple-specialist architecture as well. With multi-manager portfolios, even when selected managers have well-defined growth or value disciplines, there is increased potential for securities overlap.

► **No Manual Rebalancing**

By closely mirroring the characteristics of the U.S. equity market, an all-cap portfolio inherently maintains cap and style diversity. The need to make manual rebalancing decisions is eliminated. Rebalancing becomes completely transparent to the investor. Investors' emotions—greed and fear—no longer pose a challenge to the goal of broad portfolio diversification. Investors no longer have to fight their emotions in moving money away from a hot style or manager to an underperforming one.

► **Reduced Costs**

By inherently maintaining broad exposure to the marketplace, an all-cap portfolio potentially reduces the need to manually and frequently rebalance. By minimizing the number of trades or transactions that take place, an all-cap portfolio potentially decreases the impact of costs associated with those trades—if costs are lowered, the overall performance of the portfolio will be stronger.

All-Cap vs. Any-Cap: Distinctly Different Strategies

There are multiple all-cap offerings available in the marketplace today, but there can be significant differences among these strategies. It's important for investors to understand these differences, so that they can make an informed decision as to which strategy best suits their needs.

Some all-cap strategies might be more aptly titled any-cap strategies. An any-cap strategy has the flexibility to utilize all market cap ranges and styles, but may not provide broad equity exposure at all times. An any-cap strategy could potentially take a more active approach to asset allocation and may significantly overweight or underweight a sector, market cap, or style based on perceived opportunities or trends in the marketplace. Such an approach relies heavily on the skill of a manager and potentially raises the volatility and risk of the portfolio overall.

An any-cap strategy may be more suitable for investors who are entirely confident that their manager has a perfect or near-perfect ability to select the next best performing style/cap segment at all points in time, and who are able to tolerate higher levels of volatility in the hopes of achieving increased returns. These investors may want to consider, still, the potential cost impact of trading that typically occurs more frequently when employing an active strategy.

For investors seeking to employ a more risk-controlled, benchmark-aware approach, an authentic all-cap portfolio may be the better option. A portfolio that covers all style and



all market cap ranges, and that closely resembles the wide-ranging U.S. equity market at all times, could offer truly broad diversification that translates into genuine risk-sensitive equity exposure.

How to Use an All-Cap Portfolio

Simple Portfolio Strategy

As a result of its simplified structure, smaller investors may choose to use a single all-cap portfolio in order to achieve nicely diversified exposure to the broad domestic equity marketplace. Then, should investors want a tactical tilt towards a particular sector, style or market-cap—e.g. they feel it’s a good time to be weighted towards small cap—they can use a mutual fund or an ETF to gain extended weighting. Investors could also combine a multi-style/multi-cap portfolio with other asset classes, such as international equity, to achieve even broader diversification. Managing and monitoring these holdings remains relatively easy.

Core & Explore Strategy

A second approach utilizes a multi-style/multi-cap portfolio as the anchor tenant of a “core and explore” strategy. Some investors, in seeking broad equity exposure, may split an allocation evenly between growth and value. But in doing this, they could miss out on critical industry or sector opportunities. Additionally, this approach could require frequent rebalancing to maintain the allocation mix between styles.

Alternatively, investors may want to consider using an all-cap portfolio as the core component of a core and explore strategy in order to help reduce the volatility of the total portfolio and achieve a better-diversified, potentially more effective solution. For example, an investor could allocate the majority of his or her investment dollars to an all-cap core and then allocate the remaining capital evenly between growth and value. Using an all-cap core potentially offers the same relative return potential, while reducing the standard deviation and lowering the overall risk of the portfolio.

Likewise, an investor could allocate the remaining capital to non-correlated strategies or asset classes—such as emerging markets, international, or fixed income—that have the potential to deliver better diversification and improve overall portfolio health. Additionally, using an all-cap core could reduce the frequency and cost impact of rebalancing.

Conclusion

A multi-specialist manager architecture, while a conventional method for achieving broad equity diversification, may not be the most effective or economical approach. Realizing



better-than-market returns while seeking to mirror the characteristics of the equity market is extremely difficult to do considering the impact of transaction and management fees. A multi-style/multi-cap portfolio could provide investors with a simple, manageable, risk-controlled means to achieve broad equity market exposure and to improve overall equity portfolio performance.

Disclosure

***This material is for your private information.** The views expressed are the views of Advanced Investment Partners through the period ended June 30, 2008 and are subject to change based on market and other conditions. The opinions expressed may differ from those with different investment philosophies. The information we provide does not constitute investment advice and it should not be relied on as such. It should not be considered a solicitation to buy or an offer to sell a security. It does not take into account any investor's particular investment objectives, strategies, tax status or investment horizon. We encourage you to consult your tax or financial advisor. All material has been obtained from sources believed to be reliable, but its accuracy is not guaranteed. There is no representation or warranty as to the current accuracy of, nor liability for, decisions based on such information. Past performance is no guarantee of future results. This document contains certain statements that may be deemed to be forward-looking statements. All statements, other than historical facts, contained within this article that address activities, events or developments that Advanced Investment Partners expects, believes or anticipates will or may occur in the future are forward-looking statements. These statements are based on certain assumptions and analyses made by Advanced Investment Partners in light of its experience and perception of historical trends, current conditions, expected future developments and other factors it believes are appropriate in the circumstances, many of which are detailed herein. Such statements are subject to a number of assumptions, risks, uncertainties, many of which are beyond Advanced Investment Partners' control. Readers are cautioned that any such statements are not guarantees of any future performance and that actual results or developments may differ materially from those projected in the forward-looking statements.*

Notice: Although the information contained in this publication has been prepared by sources deemed to be reliable and is believed to be accurate as of the date referenced, there is no representation, nor warranty as to the current accuracy of, nor liability for, decisions based on such information.

Frank Russell Company ("FRC") is the source and owner of the Russell Index data contained or reflected in this material and all trademarks and copyrights related thereto. The presentation may contain confidential information and unauthorized use, disclosure, copying, dissemination, or redistribution is strictly prohibited. This is an AIP presentation of the Russell Index data. Frank Russell Company is not responsible for the formatting or configuration of this material or for any inaccuracy in AIP's presentation thereof.

All indices are unmanaged and performance of the indices includes reinvestment of dividends and interest income, unless otherwise noted. The indices are not illustrative of any particular investment and it is not possible to invest directly in an index.

All investing involves risk. Advanced Investment Partners, LLC encourages investors to seek the advice of well-qualified financial advisers, accountants, attorneys and other professionals before making any investment decision.

This material or any portion thereof may not be reprinted or redistributed without the written consent of Advanced Investment Partners, LLC.