

# AllCap Strategy

## Q3 2009 INVESTMENT UPDATE



ADVANCED INVESTMENT PARTNERS

### Market Overview

#### US Equities

The third quarter of 2009 saw a continuation of the “low-quality” rally which began on March 10, albeit in slightly less extreme fashion. As the dollar weakens on the back of “quantitative easing” (i.e., a ramped-up printing press) and massive projected budget deficits, everything priced in greenbacks is reflating. Count stocks among the beneficiaries.

As discussed last quarter, the increased risk appetite of equity buyers manifests itself in many ways, including a preference for more volatile stocks. To wit, mid-cap stocks outperformed all capitalization groups, the Russell Midcap® 800 Index advancing 20.6%. This group was followed closely by small-cap stocks, the Russell 2000® Index leaping 19.3%. Mega-cap stocks trailed by a sizeable gap, albeit the Russell Top 200® Index recording a hefty 14.4% return for the third quarter.

In the same vein, value stocks outperformed growth stocks by a wide margin across the entire market capitalization spectrum. Value outperformance is typical as the economy shows signs of reaching the end of a recession, as investors alter their mindset toward “a rising tide lifts all boats”. The absolute best performing style group was the **Russell MidCap® Value Index**, which soared 23.6% during the quarter. Next best was the **Russell 2000® Value Index**, which climbed 22.7%. As during the second quarter, the worst performing style index was the **Russell Top 200® Growth Index** (still up 12.7%), with the **Russell 2000® Growth Index** next worst (up 16.0% for the quarter).

**Technology** stocks continue to be the Russell 3000's most consistent performers, tacking on another 17.3% gain during the third quarter; the sector is up a whopping 48.7% year-to-date. **Financial Services** stocks continue their collective recovery, crawling back from death's door by adding another 23.8% in the third quarter. The sector has actually advanced better than 19% for the calendar year. Staying with the aforementioned “this has everything to do with risk appetite” theme, **Utilities** and **Health Care** stocks fared worst during the quarter just ended, with gains of 6.2% and 10.1%, respectively.

### Portfolio Review

We were behind the Russell 3000 during the third quarter. However, a few exposures helped active performance: a marginal underweight to Consumer Durables, Health Care and Utilities sectors and a moderate exposure to stocks with lower-than-average price momentum and size exposures benefited the portfolio. Some of the new positions that fared quite well during the quarter include rail transportation provider **Kansas City Southern (KSU)**, energy concern **Rosetta Resources (ROSE)** and specialty materials and chemicals producer **W.R. Grace & Co. (GRA)**. Kansas City Southern outperformed the Russell 3000® Index by over 33.4% and Rosetta Resources and W.R. Grace topped the Russell 3000® Index by 19.0% and 16.9%, respectively, since their initial purchase this quarter.

Overweight to the Financials and Materials sectors along with moderate tilt against value stocks hurt active performance. Two of the new additions which didn't perform as expected were specialty chemical maker **OM Group (OMG)**

### Investment Team

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### Firm Overview

- A pioneer in advanced quantitative investment strategies
- Founded in 1996
- Principals own meaningful equity stake
- Manages the following strategies for clients in the US and Europe:
  - MaxCap
  - MaxCap Value
  - LargeCap
  - Sustainable Responsible LargeCap
  - AllCap
  - TaxManaged AllCap
  - TaxManaged LargeCap
  - SMidCap

and communication technology provider **Arris Group** (ARRS). OM Group trailed the Russell 3000® Index by 11.1% whereas Arris Group trailed the index by 9.4%.

## Portfolio Changes

We increased the portfolio's exposure to the Retail sector, adding 2.6% via new positions in **J.C. Penney Company** (JCP) and **Home Depot** (HD). The portfolio has a moderate overweight to the sector. We also increased our exposure to the Utilities sector by 2.5%, initiating positions in **Constellation Energy** (CEG) and **Centerpoint Energy** (CNP). The portfolio has a modest underweight to the Utilities sector.

### Top Active Weights - 09/30/09

Top Five Overweights vs. Russell 3000	Portfolio
Freeport-McMoRan Copper & Gold	2.77%
eBay	2.52
General Dynamics	2.37
Eli Lilly & Company	2.09
Diamond Offshore Drilling	2.09
Top Five Underweights vs. Russell 3000	Portfolio
General Electric	-1.54%
Apple	-1.45
AT&T	-1.42
Bank of America	-1.28
Cisco Systems	-1.16

We reduced the portfolio's exposure to the Consumer Discretionary sector by about 4.1%, liquidating positions in **Cablevision Systems** (CVC), **DR Horton** (DHI), **Vail Resorts** (MTN), **McDonalds** (MCD) and **National Presto Industries** (NPK). The portfolio has a residual underweight to the Consumer Discretionary sector. We continued to trim the portfolio's exposure to the Services sector by exiting positions in **Hewitt Associates** (HEW) and **ITT Educational Services** (ESI). The portfolio has a moderate underweight to the Services sector.

## Recent Transactions

As a reminder, our quantitative portfolio management process places emphasis on the construction of an entire portfolio, seeking to maintain a risk profile very similar to that of our Russell 3000 benchmark with a higher

return potential. Stocks are included in the portfolio not only for their expected return, but also for their contribution to the portfolio's risk profile.

## Purchases

**Kansas City Southern (KSU)** provides domestic and international rail transportation services in the United States and Mexico. It operates north/south rail between Kansas City, Missouri, and various ports along the Gulf of Mexico. The company also operates direct rail passageway between Mexico City and Laredo, Texas. The company was founded in 1962 and is based in Kansas City, Missouri. Favorable drivers underlying the strong forecast for KSU include market capitalization combined with strong trading pattern. As mentioned earlier, KSU trounced the benchmark Russell 3000 by well over 33% since the initial purchase on July 21st.

	Portfolio Weight	Russell 3000 Weight
Consumer Discretionary	6.15%	6.30%
Consumer Staples	10.14	9.14
Energy	11.96	9.86
Financials	20.44	16.67
Health Care	11.27	12.56
Industrials	5.60	7.46
Materials	6.98	5.50
Retail	8.04	5.51
Services	2.47	6.17
Technology	14.72	17.10
Utilities	2.23	3.73

**Arrow Electronics (ARW)** distributes a range of electronic components and enterprise computing products, services, and solutions to industrial and commercial users worldwide. The company also offers access infrastructure, security, and virtualization software solutions. In addition, the company provides materials planning, design services, programming and assembly services, inventory management, and a suite of online supply chain tools. The company was founded in 1935 and is based in Melville, New York. Our models rated ARW a strong buy, in part due to solid return on capital. The stock has outperformed the Russell 3000 Index by over 9.1% since our initial purchase on July 21st.

**Harris Corporation (HRS)** is a communications and information technology company that serves government and commercial markets worldwide. The company was founded in 1916 and is based in Melbourne, Florida. HRS shows good prospects for long term price momentum and earnings yield. The stock outperformed the Russell 3000 Index by about 5.6% since its addition on Sep. 1st.

### Sells

**Oracle Corporation (ORCL)** engages in the development, manufacture, distribution, servicing, and marketing of database, middleware, and application software worldwide. The company distributes its products and services to resellers, system integrators/implementers, consultants, education providers, Internet service providers, network integrators, and independent software vendors. The company was founded in 1977 and is headquartered in Redwood City, California. We exited the position in ORCL on July 21st, as the stock's performance was not to our initial expectations and our models indicated unfavorable trading patterns for the company's stock.

**DR Horton (DHI)** operates as a homebuilding company in the United States. The company's homebuilding business engages in the acquisition and development of land for residential purposes, and construction and sale of residential homes. It builds traditional single-family detached homes and attached homes, such as town homes, duplexes, triplexes, and condominiums. Poor earnings quality and return on capital figures led our models to an unattractive rating for DHI. We exited the position on Aug. 4th, and the stock's performance essentially matched Russell 3000's during the holding period.

**Goldman Sachs (GS)** provides various investment banking, securities, and investment management services to corporations, financial institutions, governments, and high-net-worth individuals worldwide. The company was founded in 1869 and is headquartered in New York, New York. We exited the position in GS on Sep. 29th. The stock managed to outperform the Russell 3000 Index by 3.2% during the holding period and our models indicated poor prospects for the stock's longer term price momentum as well as earnings yield.

### Market Outlook

Let's take a moment to stand on the shoulders of giants and look ahead. Firstly, in an article penned for the Wall Street Journal, James Grant (editor of Grant's Interest Rate Observer) notes, "the deeper the slump, the zipper the recovery", and that there are no exceptions to this rule. Further, he cites English economist Arthur C. Pigou's observation that "the error of optimism dies in the crisis, but in dying gives birth to an error of pessimism. This new error is born not an infant, but a giant."

I often conclude our quarterly commentary with a reminder of the tenets of our investment methodology, including discipline, objectivity, and adaptability. Grant himself invokes the words of an investing giant (Henry Singleton, longtime CEO of Teledyne, whom Warren Buffet described as the best allocator of capital):

"I know a lot of people have very strong and definite plans that they've worked out on all kinds of things, but we're subject to a tremendous number of outside influences and the vast majority of them cannot be predicted. So my idea is to stay flexible." Count on us to emulate this.

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Investors cannot invest directly in an index. These indexes are not managed or sold by Advanced Investment Partners.

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