

# AllCap Strategy

## Q4 2009 INVESTMENT UPDATE



ADVANCED INVESTMENT PARTNERS

### Market Overview

#### US Equities

If Rip Van Winkle nodded off under a shade tree on December 31st, 2008, and slept 5% as long as depicted in his legendary tale, he'd be reading of broad US equity advances totaling 20–40% (depending on the index). And he'd likely have a less furrowed brow—and fewer gray hairs—than those of us who were white-knuckled under the green lampshade all year. This was an exciting—if at times harrowing—ride.

After a bit of a breather in the early half Q4, the final month of 2009 saw a return to the high risk/low quality rally which began on March 10th. We have considerable disdain for the phrase “window dressing”, but in this case, the shoe fits. When taken on the whole, the fourth quarter showed a relative increase in risk aversion for the first time since the market bottomed last spring. Contrary to the prior two quarters, stocks in the larger end of the market cap spectrum performed best last quarter, and the smallest stocks were laggards. To wit, the **Russell Top 200® Index** advanced 6.1%, followed closely by the large-cap **Russell 1000® Index** (up 6.0%). Small-cap stocks, while still recording a sizeable gain of 3.9%, were the worst performing cap group.

Growth stocks are seen as higher quality issues, and the relative increase in risk aversion contributed to these stocks leading the pack. Within each market capitalization segment, growth stocks outstripped their value counterparts. The best-performing style group was mega-cap growth; the **Russell Top 200® Growth Index** surged 8.4%. The worst-performing style group was small-cap value stocks; the **Russell 2000® Value Index** advanced 3.6% nonetheless.

All sectors within the **Russell 3000® Index** posted double-digit gains during 2009. Given the massive outflows from US equity accounts early during 2009, we'd suppose not many investors believed we'd wind up with such solid returns! **Technology** stocks paced the pack during Q4, just as they'd done throughout the year. For the quarter, the sector advanced 10.2%; for the year, the sector screamed 61.8% higher. The relatively safe **Utilities** and **Telecom** sectors were laggards on the year, yet advanced 12.5% and 12.7%, respectively.

### Portfolio Review

Relative performance was roughly even with the Russell 3000 during the fourth quarter. Benefiting the portfolio's performance in the quarter were a tilt towards stock with smaller market capitalization, an underweight to the **Healthcare** sector, and a slight overweight to the **Basic Materials** sector.

Notable new additions to the portfolio included **King Pharmaceuticals (KG)**, communications product maker **Anixter Intl Inc (AXE)**, and paper products producer **Domtar Corp (UFS)**. King Pharmaceuticals outperformed the index by 6.7% while Anixter and Domtar outperformed the Russell 3000 Index by 5.9% and 7.0%, respectively, since their inclusion into the portfolio.

A marginal overweight to the **Financials** sector coupled with a slight underweight to the **Telecom** sector detracted from performance during the quarter. We did

### 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

a poor job with stock selection as well. Two of the new additions that didn't perform to short-term expectations were **PNC Financial Services Group (PNC)**, which trailed the index by 8.7%, and **Peabody Energy Corp (BTU)**, which lagged the Index by 1.8% during the fourth quarter.

## Portfolio Changes

No significant changes to sector allocation were made during the past quarter. We increased our exposure to the Consumer Staples sector by 2.1%, primarily via an addition of 1.7% to our holding in home product behemoth **Proctor and Gamble (PG)**.

### Top Active Weights - 12/31/09

Top Five Overweights vs. Russell 3000	Portfolio
Freeport-McMoRan Copper & Gold	3.08%
Conoco Phillips	2.97
Home Depot	2.90
Time Warner	2.59
Harris	2.42
Top Five Underweights vs. Russell 3000	Portfolio
Apple	-1.57%
AT&T	-1.38
General Electric	-1.34
Google	-1.24
Cisco Systems	-1.15

We decreased the exposure to the Retail sector by 1.3%, liquidating positions in apparel concerns **Gap (GPS)** and **Macy's (M)**. The largest sector reduction - 1.8% - was in the Energy sector. This decrease resulted from sales of **Diamond Offshore Drilling (DO)** and **Chevron (CVX)**. Both the Retail and Energy sectors finished the year modestly overweight to the benchmark's sector allocation.

## 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

**Anixter International Inc (AXE)** distributes communications products, specialty wire and cable products, fasteners, and small parts. It serves various industries, which comprise manufacturing, telecommunications, Internet service providers, finance, education, healthcare, transportation, utilities, aerospace and defense, and government, as well as contractors, installers, system integrators, value-added resellers, architects, engineers, and wholesale distributors. Anixter International distributes its products in the United States, Canada, Europe, Asia Pacific, and Latin America. The attractive rating on AXE is attributable to strong cash-based return on capital and favorable earnings to debt.

	Portfolio Weight	Russell 3000 Weight
Consumer Discretionary	4.87%	6.13%
Consumer Staples	12.18	9.12
Energy	10.25	9.93
Financials	19.89	16.19
Health Care	9.60	11.50
Industrials	6.11	7.60
Materials	7.54	5.70
Retail	6.70	5.46
Services	3.63	6.31
Technology	16.36	18.29
Utilities	2.88	3.76

**Wellcare Health Plans (WCG)** provides managed care services for government-sponsored health care programs in the United States. The company offers Medicaid and Medicare plans, including health plans for families, children, aged, blind, and disabled, as well as prescription drug plans. WellCare Health Plans, Inc. was founded in 1985 and is headquartered in Tampa, Florida. WCG's reported earnings are strong relative to capital, as was operating cash flow.

**IntercontinentalExchange (ICE)** owns and operates an Internet-based global electronic marketplace for trading in futures and over-the-counter (OTC) commodities, and derivative financial products in the United States, the United Kingdom, and Canada. Its products include contracts based on crude and refined oil products, natural gas, power, coal, sugar, cotton,

coffee, cocoa, canola, orange juice, credit default swaps, and foreign exchange and equity index products. ICE serves professional traders, financial institutions, institutional and individual investors, corporations, manufacturers, commodity producers and refiners, and governmental bodies. The positive forecast for ICE is based on earnings quality and earnings yield.

## Sells

**Macy's Incorporated (M)** operates department stores in the United States. As of January 31, 2009, it operated approximately 840 retail stores in 45 states, the District of Columbia, Guam, and Puerto Rico under the names Macy's and Bloomingdale's. While Macy's had been an 11% underperformer during the second quarter when the position was added, it has since rebounded robustly. We exited the position on October 27th as the stock realized and exceeded return expectations, outperforming the index by 25% during our holding period. The forecast had also turned increasingly negative due to its technical outlook.

**Arrow Electronics (ARW)** distributes a range of electronic components and enterprise computing products, services, and solutions to industrial and commercial users worldwide. Its customers include the manufacturers of consumer and industrial equipment, telecommunication products, automotive and transportation, aircraft and aerospace equipment, scientific and medical devices, and computer and office products. Arrow underperformed the benchmark by just over 2% during the holding period and we liquidated the position on November 24th. The stock became unattractive due to an unfavorable forecasted earnings to price ratio.

**Swift Energy (SFY)** engages in developing, exploring, acquiring, and operating oil and natural gas properties in Louisiana and Texas. Swift outperformed the index by 6% over the holding period and we exited the position on November 24th due to deteriorating earnings and cash flow ratio forecasts.

## Market Outlook

Bill Gross and Robert Rodriguez are two investors who merit tremendous respect. Given their respective 25+ year histories of outstanding performance in the fixed income market, I found it interesting that each wrote a similar missive to cap 2009. Each notes the reckless spending governments have made commonplace. All fiscal discipline has been tossed aside; there is no plan to balance the budget, let alone reduce debt already outstanding. To exacerbate this problem, currency printing presses ran full bore for most of late 2008 and 2009, sending our debt as a percentage of GDP higher by some 20%. This will indeed hamper long-term growth potential, and investors will have to reckon with the retraction of at least a portion of this liquidity in 2010.

Assumptions for 2010 are quite bullish, 1250 for the S&P 500 seems to be the consensus from market mavens. This presumes robust earnings growth, and a steady P/E ratio. The P/E risk is to the downside, as market P/E is inversely correlated with inflation. Corporate earnings growth must be derived from real demand, as cost-cutting and inventory rebuilding effects will fade by mid-year. 1250 on the S&P would be nice, but we believe we'll end 2010 a few percent lower than that level. We also expect the reflation trade of the past 9 months will recede, and we will again need to adapt our strategy accordingly.

## Disclosure

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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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