

# SMidCap 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.

A near three-way dead heat highlights the 2009 sector performance summary for the **Russell 2500™ Index**. **Consumer Discretionary** stocks returned 60.9%, **Technology** stocks added 60.5%, and **Energy** stocks trailed narrowly, tacking on an additional 60.0%. **Financials** was the worst performing sector, but few'd have thought the sector would have managed a 6.6% advance after witnessing performance during the first quarter of 2009.

### Portfolio Review

The SMidCap strategy outperformed the Russell 2500 Index during the fourth quarter, led by a positive contribution from individual stock selection. Active performance was also boosted by an underweight to the **Health Care** sector. Top-performing additions to the portfolio include managed care provider **WellCare Health Plans** (WCG), process management solutions provider **Moduslink Global Solutions** (MLNK), and real estate developer and natural resource company **Forestar Group** (FOR). These stocks outpaced the benchmark Russell 2500 Index by 37.5%, 16.3%, and 8.4% respectively, since we initiated the holdings.

An underweight to Technology coupled with a small overweight to the **Consumer Services** sector impaired performance during the quarter. Our worst-performing additions to the portfolio were **Zions Bancorp** (ZION), **Central European Distribution Corp** (CEDC), and **Seachange International** (SEAC). These positions underperformed the benchmark by 32.1%, 20.5%, and 19.5%, respectively.

### 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

## Portfolio Changes

We increased the portfolio's exposure to the Services and Technology sectors last quarter, reversing the trend of trimming Technology the previous two quarters. New positions include **Clear Channel Outdoor Holdings** (CCO) and **FactSet Research Systems** (FDS) in the Services sector along with new positions in **Teradyne** (TER) and **Digital River** (DRIV) in the Technology sector.

We significantly reduced our exposure to the Energy sector, moving from a moderate overweight to a moderate underweight. We liquidated positions in **Cimarex Energy** (XEC), **Tesoro Corp** (TSO), and **St. Mary's Land and Exploration** (SM). We trimmed a large overweight in the Consumer Discretionary sector by liquidating the position in **National Presto Industries** (NPK), and reducing our positions in **Mohawk Industries** (MHK) and with **KBR** (KBR).

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

Top Five Overweights vs. Russell 2500	Portfolio
W.R. Grace & Co	1.93%
Integrus Energy	1.73
GrafTech	1.73
Anixter	1.69
Centerpoint Energy	1.56
Top Five Underweights vs. Russell 2500	Portfolio
CenturyTel	-0.50%
SAIC	-0.35
Red Hat	-0.27
Cree	-0.27
Human Genome Sciences	-0.26

## 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 2500 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

**Airgas Incorporated** (ARG) distributes industrial, medical, and specialty gases, as well as hardgoods in the United States. The company was founded in 1982 and is based in Radnor, Pennsylvania. Very strong return

on capital figures – whether measured by cash flow or reported earnings – buoyed our forecast for this stock.

**Seachange International** (SEAC) develops, manufactures, and markets digital video systems worldwide. The company operates in three segments: Software, Servers and Storage, and Media Services. The company sells its products directly, as well as through independent agents and distributors. Seachange's forecasted excess return was driven in large part by its favorable trading pattern – the stock looked positioned for an oversold bounce.

**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 were strong relative to capital, as was operating cash flow.

	Portfolio Weight	Russell 2500 Weight
Consumer Discretionary	12.96%	9.42%
Consumer Staples	1.46	3.61
Energy	3.22	5.22
Financials	17.97	19.32
Health Care	8.54	11.31
Industrials	8.26	9.10
Materials	8.04	7.42
Retail	9.07	5.75
Services	12.11	8.99
Technology	10.79	14.52
Utilities	7.58	5.26

## Sells

**Advisory Board** (ABCO) provides best practices research, analysis, executive education and leadership development, business intelligence software tools, and installation support services primarily to the health care industry. Its programs focus on business strategy, operations, and general management issues. ABCO performed much better than the Russell 2500 Index during our holding period, topping the index by 22.3%. Advisory Board's cash flow pattern appeared to be deteriorating, and we exited the position on October 13th.

**Amcol International (ACO)** operates as a specialty minerals company in the Americas, Europe, and the Asia Pacific. The company was formerly known as American Colloid Company and changed its name to AMCOL International Corporation in 1995. A combination of a weak short-term trading pattern and poor earnings resulted in a deteriorating forecast from our models. We exited the position on October 13th, and the stock lagged the Russell 2500 Index by 12.6% during the holding period.

**Jabil Circuit (JBL)** provides electronic manufacturing services and solutions in the Americas, Europe, and Asia. It offers electronics and mechanical design, production, product management, and after-market services to companies in the aerospace, automotive, computing, consumer, defense, industrial, instrumentation, medical, networking, peripherals, storage, and telecommunications industries. This was another October 13th sale, and JBL trumped the Russell 2500 Index by 52.3% during our holding period. Earnings yield is not being favored by Technology investors, and the company's relatively high earnings yield combined with poor return on capital drove a poor return forecast for this stock.

## 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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