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Using Secondary Benchmarks to Improve Portfolio Structure

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Security valuation is typically viewed as the more glamorous aspect of an investment process, while portfolio construction and implementation are viewed as relatively more pedestrian. However, it's not enough to have informed insights into the individual attractiveness of a universe of securities; it's equally important how those insights are captured and translated into a well-structured portfolio aimed at satisfying strategic and client objectives.

Our portfolio risk management process is focused on active risk – i.e., how our assessments of individual security attractiveness lead our portfolio to beta, industry, individual security and other characteristic departures from the primary benchmark's profile. For some of our strategies' portfolios we are also interested in managing departures from a secondary benchmark. Specifically, we make use of primary as well as secondary benchmarks when constructing the portfolios for our tax-managed and socially responsible strategies.

Incorporating Secondary Benchmarks

The use of secondary benchmarks is beneficial in addressing situations where a strategy has a clearly identified second point of reference which is important to consider in addition to the strategy's primary performance benchmark. When constructing a typical portfolio relative to a single primary benchmark, a single optimal portfolio will not exist; instead, there will be several similarly optimal portfolio solutions available. When a meaningful secondary benchmark is introduced, a manager can effectively narrow the choice among the similarly optimal portfolios by selecting the portfolio that coincidentally yields the best fit relative to both the primary and secondary benchmarks. This approach of using both primary and secondary benchmarks allows us to explicitly manage exposures to the characteristics of two benchmarks simultaneously.

A common use of secondary benchmarks for managers is during portfolio optimization when managing a portfolio through an anticipated benchmark reconstitution. For instance, a strategy that is closely managed to one of the Russell indexes, which undergo regular reconstitutions, the manager can incorporate the preliminarily announced version(s) of the reconstituted index as a secondary benchmark while continuing to use the current, pre-reconstituted index as the primary benchmark. This approach will allow the manager to properly anticipate the impact of reconstitution, which will aid in minimizing the jump in risk that would occur once the index reconstitution actually takes effect.

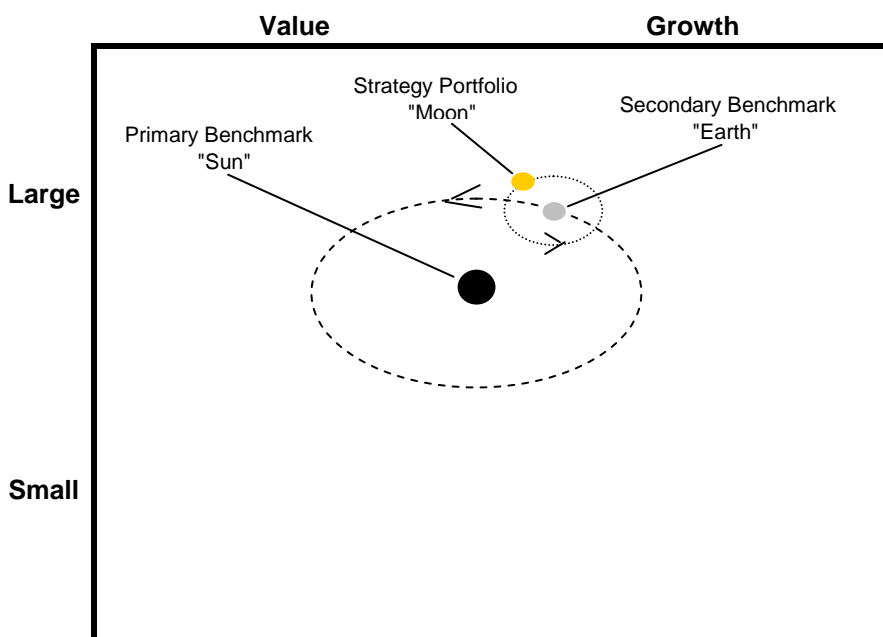
At Advanced Investment Partners, we have successfully incorporated secondary benchmarks within the management of our TaxManaged LargeCap, TaxManaged AllCap and Socially Responsible LargeCap strategies. For example, our TaxManaged LargeCap strategy has the S&P 500 as a primary benchmark, but it also employs a secondary benchmark of the regular, non-tax-managed LargeCap portfolio. The objective for our TaxManaged LargeCap strategy is to outperform the S&P 500 Index in a tax efficient manner while looking as much like the non-tax managed LargeCap portfolio as possible. Therefore, the management of a client's TaxManaged LargeCap portfolio is a triangulation of sorts between the S&P 500 Index, the non-tax managed LargeCap portfolio, and the client's current portfolio of taxable holdings.

Similar to the TaxManaged LargeCap strategy, our Socially Responsible LargeCap strategy has the S&P 500 as a primary benchmark and the regular LargeCap strategy's portfolio as a secondary benchmark. The Socially Responsible LargeCap strategy's objective is to outperform the S&P 500

using only stocks of socially responsible companies while looking as much like the regular LargeCap portfolio as possible. For this strategy the portfolio is a triangulation of the S&P 500, the regular LargeCap portfolio, and a universe of stocks that have been individually evaluated for social responsibility.

A useful analogy for portraying the impact on a strategy's portfolio when primary and secondary benchmarks are employed is the orbital relationship between the sun, earth and moon. For illustrative purposes the sun will represent the primary benchmark, the earth the secondary benchmark and the strategy's managed portfolio the moon (see Chart 1).

Chart 1



The Moon orbits both the Sun and the Earth, but its orbit around the Earth is much tighter. Similarly, our tax managed and socially responsible strategies' portfolios have managed departures from both the primary and secondary benchmarks, but the departures from the secondary benchmark is at a much lower level of active risk than the active risk relative to the strategy's primary benchmark. This structure for constructing our tax-managed and socially responsible portfolios allows us to maintain characteristics very close to the underlying strategy while satisfying the additional objectives of tax management and socially responsibility, respectively.

During 2007 we also implemented a secondary benchmark within the portfolio management process for our regular AllCap strategy. The following discussion details our considerations during this strategy enhancement as a case study to further clarify the benefits of using secondary benchmarks.



Case Study: Introducing a Secondary Benchmark into the AllCap Strategy

Our AllCap strategy is a core strategy benchmarked to the Russell 3000[®] Index and is structured as a distillation of the combined LargeCap and SMidCap strategy portfolios. The LargeCap portfolio (typically with 65 positions), and the SMidCap portfolio (typically with 130 positions), are distilled into an AllCap portfolio (typically holding about 60 positions) by optimally sampling the higher expectation holdings from the individual LargeCap and SMidCap portfolios. Given that our AllCap portfolio draws upon the LargeCap and SMidCap holdings, our expectation is for AllCap's benchmark-relative performance to be between the other two strategies with perhaps greater similarity with the LargeCap performance due to the high degree of overlap between their benchmarks – the Russell 3000[®] and the S&P 500, respectively.

As the first half of 2007 began to unfold, we observed a growing negative divergence in AllCap performance relative to the performance of LargeCap and SMidCap. In response, we initiated a full review of our AllCap portfolio management process to clearly attribute the sources of the divergence and to identify possible enhancements to our AllCap investment process that would minimize expected future divergences.

AllCap Departures from LargeCap and SMidCap

Although the AllCap holdings were sourced from the higher expectation positions from the LargeCap and SMidCap portfolios, there were material differences in aggregate portfolio characteristics. Of particular note were differences in sector weights, especially the Energy, Technology and Health Care sectors. There were differences in the portfolios' betas as well. Although the AllCap portfolio had a great deal of position overlap with the LargeCap and SMidCap portfolios, the aggregate characteristics evidenced sector differences as a source of performance departure between the three strategies. Therefore, we needed to go beyond ensuring similarity in portfolio positions and enhance our ability to foster greater similarity of portfolio characteristics.

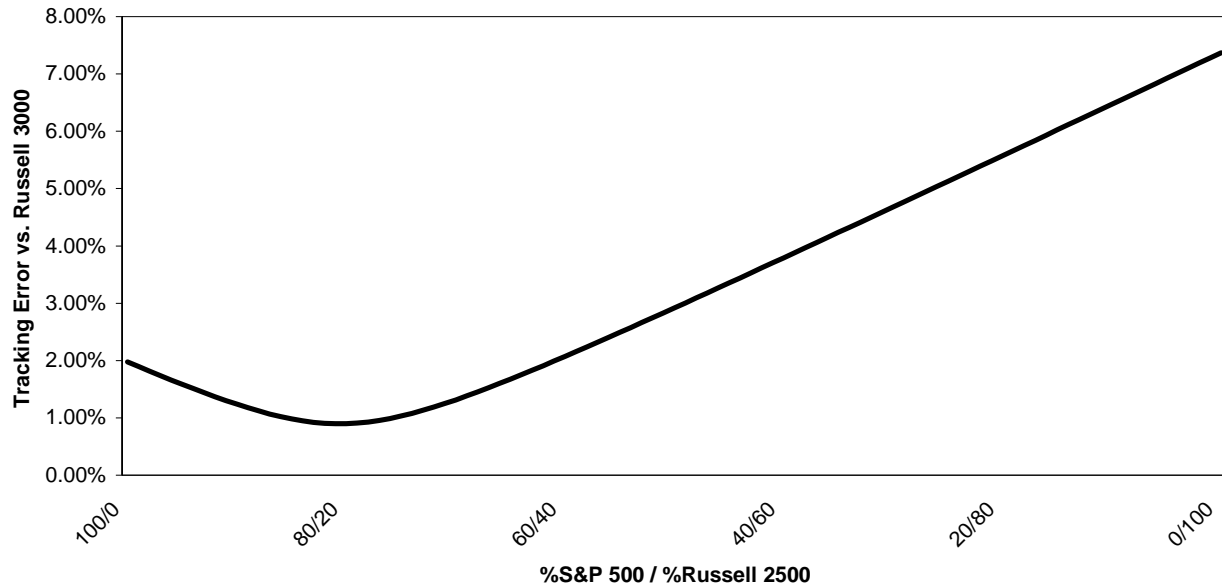
Initiating a Secondary AllCap Benchmark: LargeCap + SMidCap Aggregate

To minimize divergence in portfolio characteristics, it is necessary to be more precise about which stocks are held and in what position sizes. Sampling the more significant high expectation stocks from the LargeCap and SMidCap portfolios and weighting them appropriately should yield an AllCap portfolio with similar overall portfolio characteristics and biases as those found in the LargeCap and SMidCap portfolios. We believed that this could be accomplished by introducing a secondary benchmark for the AllCap strategy – the primary benchmark would remain the Russell 3000[®] while a secondary benchmark would be established as a LargeCap plus SMidCap aggregate portfolio.

The first step in establishing this secondary benchmark was determining the appropriate proportions when combining the individual LargeCap and SMidCap portfolios into an aggregate portfolio. This was done by looking at all possible combinations of each strategy's benchmark returns (i.e., the S&P 500 for the LargeCap and the Russell 2500[®] for the SMidCap) and evaluating which combination most closely approximated the returns for the Russell 3000[®]. Chart 2 shows the result of this analysis when performed in July 2007.

Chart 2

S&P 500 and Russell 2500 Combinations
Using Returns from January 1979 through June 2007



The chart reveals that closest fit to the Russell 3000[®] is an 80/20 proportional combination of the S&P 500 and the Russell 2500[®]. Therefore, the secondary benchmark for the AllCap strategy was established as an 80/20 combination of the LargeCap and SMidCap portfolios. This explicit linkage via a secondary benchmark should provide a measure of direct control on the AllCap portfolio's departure from its two related strategies' portfolios.

Observed Impact on Performance Divergence

The incorporation of a secondary benchmark into the AllCap portfolio management process was initiated in late July, 2007. Chart 3 compares the difference in the AllCap strategy's total return versus an 80/20 combination of the LargeCap and SMidCap strategies' total returns for three periods: 1) January through July 2007, which was prior to the usage of a secondary benchmark; 2) August through December 2007, which is the balance of calendar 2007 using the secondary benchmark; and 3) year-to-date 2008 through June. The first period displays the performance divergence observed in 2007 while the other two periods reveal the positive impact to date on divergence resulting from the implementation of the 80/20 LargeCap/SMidCap secondary benchmark for the AllCap strategy.

Chart 3

AllCap vs. 80/20 LargeCap/SMidCap Total Returns

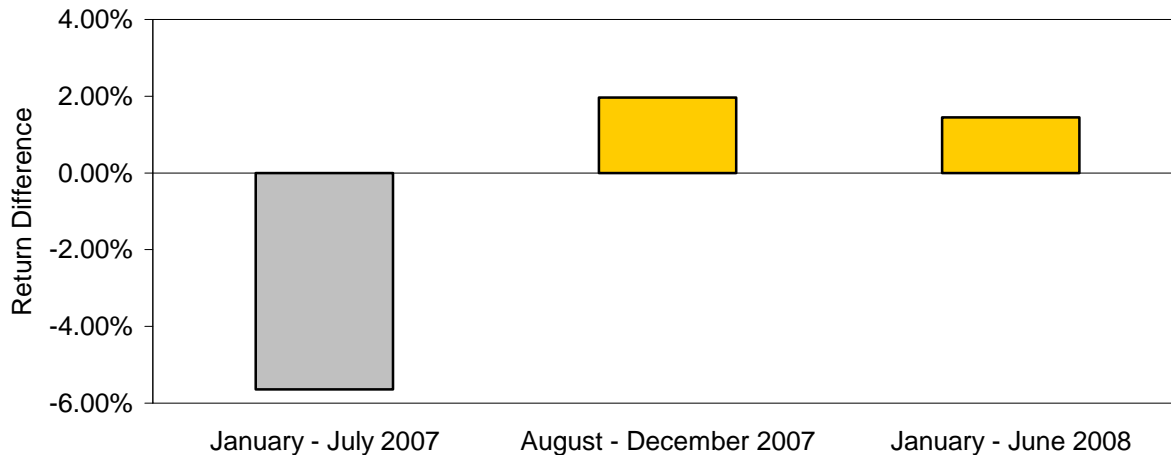


Chart 3 reveals that the AllCap strategy's negative divergence in performance from the LargeCap and SMidCap strategies was favorably corrected through the remainder of calendar 2007 and has continued through June 2008. The secondary benchmark has fostered much more similarity between the three portfolios – not just in individual positions, but also across overall portfolio characteristics.

Although not a common practice, we have clearly realized portfolio structure benefits from incorporating secondary benchmarks in conjunction with primary benchmarks when constructing the portfolios for our tax-managed, socially responsible, and now our AllCap strategies.

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