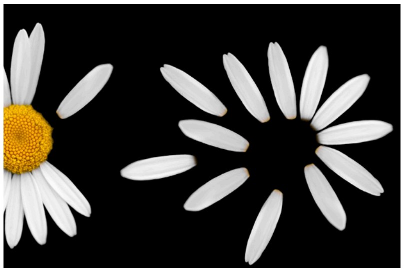
PINEBRIDGE INVESTMENTS

US Large Cap Equity: Alpha Beyond The Correlation Divide



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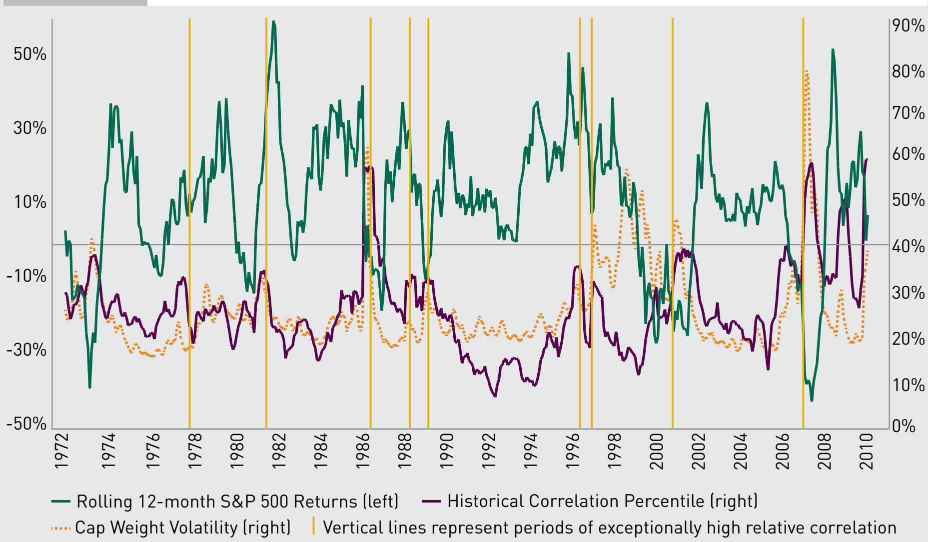
Greater Alpha-Generating Opportunities Ahead

During periods of heightened market uncertainty, investors have historically shown a tendency to develop a unified de-risking approach to investing, normally resulting in large scale sector and/or asset rotations into asset classes that many investors refer to as 'defensives' or 'safe havens'. Such rotations tend to trigger irrational investor behavior at times when markets are under duress, characterized by periods of above average market correlations, as shown in **Figure 1**. Asset prices begin to move in concert, thereby compressing the dispersion of individual stock returns. Also, fundamentals become overtaken by a sense of short-term urgency, thereby increasing market volatility. Such developments present a dilemma for actively managed portfolios that rely on fundamental bottom-up stock selection and make alpha much more elusive.

We believe that, as market visibility improves, equity correlations will decline and present a favorable backdrop for investors to pursue alpha through active management and fundamental equity research. In this scenario, the best approach for US large cap equity investors will be to pursue a strategy with significant stock-specific active risk to best reap the benefits from the significant valuation anomalies that arise after periods of strong correlations.

Performance data from US large cap active managers spanning more than three decades show that, after the end of a period of extreme correlations, even the average active manager records an annual outperformance that is 2.5x larger than the average outperformance generated during the overall period reviewed[1].

FIGURE 1 Historical Return, Correlation And Volatility Of S&P 500 Stocks: 1973 - 2011



1 Source: Sanford C. Bernstein Quantitative Research, November 2011..

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Decoupling Correlations And Active Management

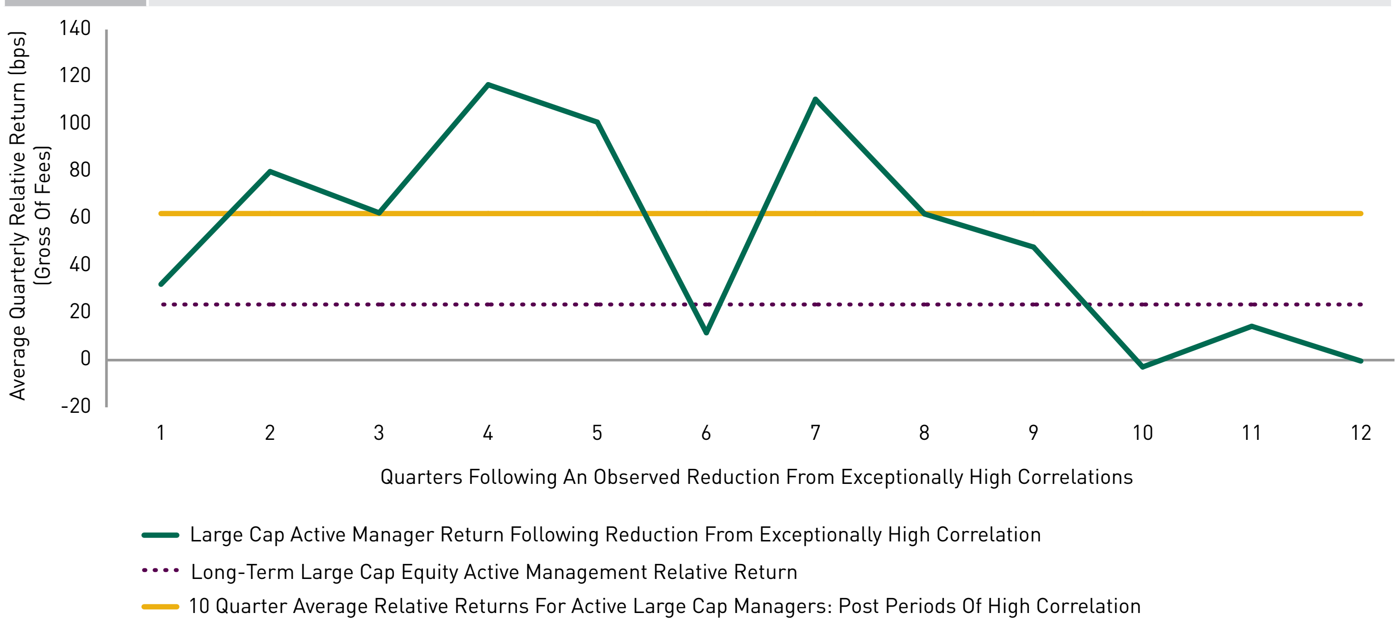
Between 1973 and 2010 there were nine instances that we would deem as having had exceptionally high levels of relative correlation, as shown in **Figure 2**. With the exception of one period, large cap active equity managers outperformed their respective benchmarks for up to an average of 10 quarters following a decline from these exceptionally high levels of correlation. The average rate of outperformance during these periods was +62bps, meaningfully exceeding the long-term rate of +24bps. This outperformance can also be seen on a risk-adjusted basis, as illustrated by the information ratio. Therefore, as the dispersion of equity returns starts to widen following high correlation periods, the opportunities to generate alpha are expected to increase.

Elusive Alpha And Focus Investing

Although alpha opportunities tend to increase with declining correlations, investors should consider how these can be best realized. In recent years, an increasing number of US large cap active managers underperformed their respective benchmark indices. Thus, when considering US large cap equity active management, investors should consider the efficient nature of this market and the challenges this presents in pursuing alpha. It is this characteristic that led to our strong belief that a concentrated portfolio consisting of high-conviction ideas is the best way to extract alpha within this market. Further, we believe that the best way to construct such a portfolio is through what we call a "Focus" approach.

In highly-developed markets, we subscribe to the view that only Focus-oriented and "truly active" managers can consistently outperform their respective benchmarks over a prolonged period. Measuring whether a manager is truly active is explored in a 2007 study conducted by the

FIGURE 2 Active Manager Quarterly Returns Following Periods Of Exceptionally High Correlations 1979-2011



Source: Sanford C. Bernstein Quantitative Research, November 2011.

Yale University School of Management in which professors Martin Cremers and Antii Petajisto highlighted the concept of "Active Share"[1]. Active Share is a measure of active risk, classified as the percentage of a portfolio that differs from the benchmark. The higher the Active Share, the more a portfolio deviates from its benchmark. Cremers and Petajisto demonstrate that truly active managers can be distinguished from what they refer to as "closet indexers" by the sharp contrast in their respective Active Share values.

When considering concentrated truly-active strategies it is important to remain cognizant that not all are created equal. In the Cremers and Petajisto study, two key types of concentrated strategy are identified: Concentrated Stock and Diversified Stock. The Diversified Stock strategy shares the characteristics of the approach that we follow in our Focus portfolios. Concentrated Stock portfolios are those that have a high Active Share, but also a high tracking error, with peer top-quartile levels above 9.2%. Diversified Stock (or "Focus") portfolios also have high Active Share, but a relatively lower tracking error, with peer bottom quartile levels below 6.1%[2], so investors seeking to maximize their risk-adjusted alpha, as defined by the information ratio, could benefit from this investment strategy. In our opinion, Concentrated Stock strategies tend to take on considerable systematic risk through factor bets and, consequently, often have pronounced swings in the relative exposure across sectors. As with many concentrated strategies, a Diversified/Focus strategy relies on a high-conviction, bottom-up analytical process. However, it differs by avoiding sizable factor bets by placing a limit on the number of stocks held per sector. As a result, a Focus approach tends to exhibit lower return volatility, which in turn can lead to a higher risk-adjusted return.

Conclusion

We believe that as market visibility improves, equity correlations will decline and present a more favorable backdrop for investors to pursue alpha through active management and fundamental equity research. In this scenario, we believe that US large cap equity investors seeking alpha could benefit greatly by applying a Diversified Stock/Focus approach. Investors often have a tendency to perceive that all Concentrated Stock strategies fall into the same bucket and achieve superior alpha by taking on higher levels of risk. However, a Focus strategy has shown to be able to consistently generate alpha while mitigating risk.

Both Focus and Concentrated Stock approaches have high levels of Active Share and, thus, have the ability to generate persistently strong alpha. However, unlike a Focus approach, a Concentrated Stock approach achieves high Active Share by greatly deviating away from the broader market by making sizable top-down tactical allocations, which normally results in a very high level of tracking error. In contrast, a Focus approach emphasizes bottom-up portfolio construction through high-conviction stock selection with a limit on the number of stocks per sector. This results in a much more diversified portfolio construct that leads to a lower level of tracking error than with a Concentrated Stock approach.

Often, a higher portfolio tracking error, typically seen in Concentrated Stock approaches, will present the opportunity to achieve a greater magnitude of excess return. However, the higher level of tracking error risk may not satisfy certain investor risk budgets and appetites. Through a Focus approach an investor can generate alpha while mitigating risk, thereby better addressing investor risk constraints and presenting an opportunity to realize a more optimal information ratio.■

1 Active Share is calculated as the sum of the absolute value of active bets between the portfolio and underlying benchmark index, divided by two. It is a range from 0% to 100%.

2 Source: eVestment as of 30 June 2011, trailing 3-year tracking error against a custom large cap core universe of portfolios with less than 30 stocks.

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Mr. Thorn joined the firm in 1998 and is now responsible for managing the firm's Active Equity teams as well as the firm's Global Equity portfolios. Mr. Thorn joined PineBridge Investments as Co-Portfolio Manager of the Global/International portfolios and Portfolio Manager focused on the health care sector. In 2000, he became Global Head of Equity Research, followed by additional responsibilities as Head of European Equities (2003), Head of US Equities (2006) and assumed the role of Head of all Developed Markets in 2007. In the fourth quarter of 2010, the Emerging Markets Equities group was added to his responsibilities. During his tenure with the firm, Mr. Thorn helped develop and implement the firm's equity process and online knowledge-sharing tools for equity investing globally. Prior to joining the firm, Mr. Thorn was a Global Health Care Portfolio Manager with SE Banken Fonder (SEB Asset Management) of Sweden. Mr. Thorn holds an MS in Economics and Business Administration from the Stockholm School of Economics with majors in Financial Economics and Economical Steering/Planning.

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Mr. Neuger joined the firm in 2002 as a Research Analyst in US Equity and is now the Managing Director and Head of US and Europe Active Equities. Mr. Neuger manages Large Cap Equity and US Large Cap Focus strategies. He remains particularly involved in the research process, as his team operates a co-research strategy, whereby portfolio managers collaborate with analysts on their best ideas early on in the decision-making cycle. Prior to joining the firm, Mr. Neuger was a Fixed Income Analyst with Wells Capital Management in Minnesota. Mr. Neuger received his BA in Economics from Saint Olaf College and an MBA in Finance and Accounting from the University of Minnesota. He is currently a Level III CFA candidate and a member of the New York Society of Securities Analysts.

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Mr. Sasaki serves as Head of Research and the Client Portfolio Manager for the PineBridge Focus Equity strategies. He joined the firm in 1999 as an Equity Analyst and served in that role for over 10 years. Prior to joining the firm, Mr. Sasaki was a Fixed Income Auditor with Credit Suisse Asset Management. He began his career in the financial industry in 1997 as an Associate at Yasuda Trust & Banking Company. Mr. Sasaki received a BS in International Business and Finance from New York University Stern School of Business and an MBA in Finance from Fordham University Graduate School of Business Administration with honorary distinction. He is a CFA charterholder and is an active member of the CFA Institute and the New York Society of Security Analysts.
