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THE CASE FOR STRUCTURED EQUITY

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► EXECUTIVE SUMMARY

A structured equity strategy seeks to add value to a passive benchmark through a disciplined stock-selection methodology coupled with a high level of risk controls. Most quantitative strategies use statistical techniques to identify companies likely to outperform their peers while maintaining sector, industry and capitalization sensitivity to benchmarks.

A universe of structured equity managers benchmarked against the S&P 500 have outperformed their fundamental peer manager strategies by nearly 70 basis points annually for the past 14 years, the longest period of significant data in the eVestment Alliance database.

The investment press has devoted significant coverage to the poor performance of quantitative-based investment managers in the third quarter of 2007. Many articles in the investment press referred to the failure of quantitative models during this period, without regard to the difference between global hedge funds and structured U.S. equity managers. Although many structured managers lagged their respective benchmarks during the quarter, the overall deviation and the impact on long-term results were within historical norms.

The rationale for including structured equity managers in a portfolio after the third quarter of 2007 should be no different than prior rationale. That is, they are designed to provide attractive risk-adjusted returns for your portfolio.

► WHY STRUCTURED EQUITY?

A structured investment strategy pursues a risk level similar to a market benchmark and seeks to add above-market returns through a disciplined approach to security selection. Structured equity strategies generate risks similar to indexing, while providing the potential for outperformance from active management. They seek to deliver the efficient trade off of risk and return.

The goal of structured equity investing is to outperform a benchmark and minimize volatility through active stock selection. In broad terms, a structured equity manager offers the risk profile of a passive index enhanced with outperformance through active stock selection. Risk management is a key part of a strategy's success, as the risk/return benefits of a structured approach gets less efficient as tracking error increases.

Structured equity approaches often use a quantitative model to identify securities and compare the risk and return trade-off of each security relative to peer companies. Although models can vary widely from firm to firm, they typically include some combination of factors drawn from broad groupings of growth, momentum, valuation, technical, and quality, among others. The model's purpose is to identify stocks positioned to outperform versus those likely to underperform. The underlying strategy is to limit or mitigate sector, industry, size and style risks and add value through stock selection. Additionally, the strategy seeks to confine risk to the stock-selection process. Many funds have taken steps to eliminate the market risks of such strategies by using the derivative markets and have "ported" this consistent source of alpha to other areas of the plan.

Many quantitative strategies are rooted in the same underlying company fundamentals that drive the processes of traditional, fundamental ("fundamental") managers, as well as strategies that combine a screening process with fundamental analysis ("combined"). The difference is that quantitative strategies are more systematic and unbiased in this application, resulting in portfolios that produce a higher return while taking on less risk.

Comparative Analysis*

Date Points	Combined	Fundamental	Quantitative
Number of Managers:	87	158	74
Tracking Error-5 years:	3.54	3.48	2.61
Tracking Error-10 years:	5.85	5.72	3.71
Excess Returns-5 years:	0.83	0.65	1.58
Excess Returns-10 years:	2.06	1.39	1.59
Information Ratio-5 years:	0.29	0.17	0.45
Information Ratio-10 years:	0.31	0.24	0.42
Correlation of Excess Returns-5 years:	0.15	0.11	0.30
Correlation of Excess Returns-10 years:	0.13	0.18	0.33

*All information as of June 30, 2007. Source: eVestment Alliance database.

The process of selecting an investment manager typically involves the review of static time periods, such as the most recent five or 10 year period. The success of quantitative-based strategies is also evident by “pushing” the data beyond the traditional time periods. For example, the eVestment Alliance database offers statistics up to a 14-year time period. And that information strongly favors quantitative-based firms over the longer time period.

Comparative Analysis**

Date Points	Combined	Fundamental	Quantitative
Number of Managers:	34	71	18
Tracking Error-14 years:	5.18	5.20	3.51
Excess Returns-14 years:	0.35	0.34	1.05
Information Ratio-14 years:	0.09	0.08	0.30
Correlation of Excess Returns-14 years:	0.13	0.17	0.34

**All information as of June 30, 2007. Source: eVestment Alliance database

Hiring a structured equity manager is similar to hiring a manager in any other area of your portfolio. You want to hire a manager most likely to replicate the results that earned that manager your attention and consideration in the first place. In addition, it is important to assess the risks a manager takes relative to a passive benchmark and other comparable strategies.

On a risk-adjusted basis, a universe of quantitative managers has a significant information ratio over all measured periods. This includes an information ratio of nearly double (0.42) that of a universe of fundamental managers (0.24) over a 10-year period and more than triple (0.30 vs. 0.08) for a 14-year period.

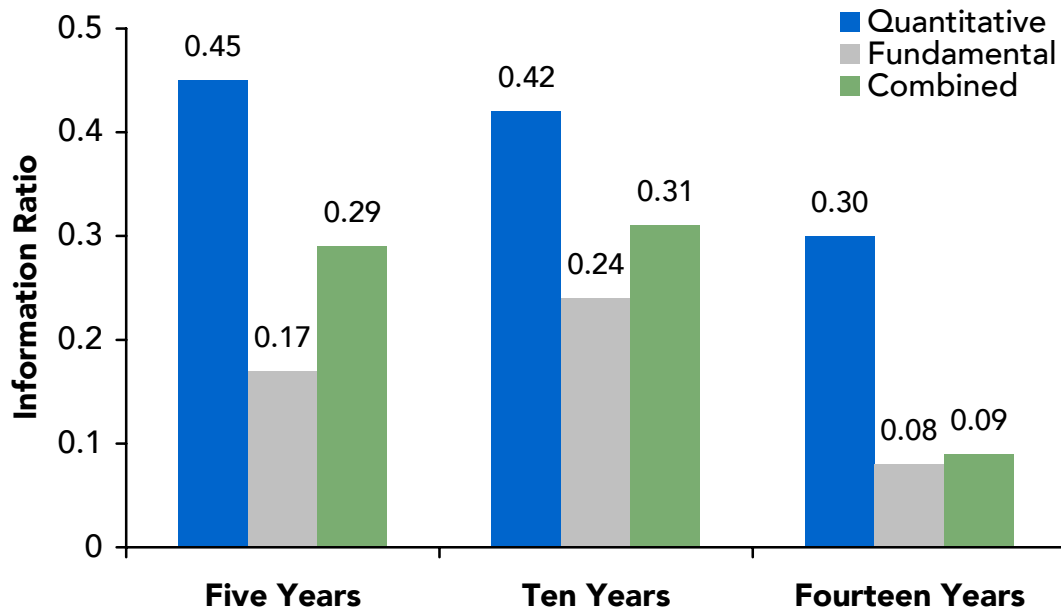
▶ LONG TERM SUCCESS IN QUANTITATIVE STRATEGIES

Numerous studies on the success of structured equity managers have been conducted during the past decade. Of note, the median structured equity manager's information ratio (defined as Callan's stock-based enhanced index universe) significantly outperformed the median traditional active manager (as defined as Callan's Broad Style Universe), according to Vanguard's 2003 paper "The Case for Structured Equity." The same pattern holds true at the 25th percentile of the same universe – suggesting your manager selection will be more amply rewarded by selecting a structured equity manager versus a traditional manager.

The Vanguard paper also showed that structured equity managers who rely on quantitative stock-selection strategies have an average information ratio of 0.45. This places the average firm among the top quartile of investment managers in a database of quantitative and traditional large cap core managers through 2002.

This same pattern of behavior holds true when we attempt to replicate the study through June 30, 2007 relying on data from the eVestment Alliance database.

Success of Structured Equity



Based on median gross of fee returns of managers in the 50th percentile of the eVestment Alliance Large Cap Core Universe. "Quantitative" is eVestment Alliance's definition of managers employing a Quantitative approach in their Large Cap Core universe. "Fundamental" is eVestment Alliance's definition of managers employing a purely Fundamental approach in their Large Cap Core universe and "Combined" typically represents managers employing some level of initial screening followed by a fundamental approach.

A universe of structured equity (“quantitative”) managers benchmarked against the S&P 500 has outperformed fundamental managers by more than 70 basis points for the 14 year period ending June 30, 2007. When using a hypothetical 40% portfolio allocation to a structured equity strategy for a domestic equity allocation, 70 basis points of outperformance equates to an additional \$28 million annually for a \$1 billion pension fund. Additionally, a 70 basis-point advantage in this allocation equals an additional 0.28% in total fund return, enough to cover a significant portion of total fund expenses for an entire plan.

Comparative Median Performance Returns for Different Investment Approaches

	Combined	Fundamental	Quantitative
5 years	11.55	11.36	12.30
10 years	9.19	8.52	8.72
14 years	11.40	11.39	12.10

*Reflects eVestment Alliance Large Cap Core universe ending June 30, 2007

► THIRD QUARTER 2007

Despite its index-like characteristics, a structured equity portfolio is an active strategy. As such, there likely will be periods in which the strategy underperforms its benchmark. What ultimately matters are the duration and the magnitude of the underperformance.

During July and August of 2007, many quantitative strategies underperformed. Several factors and relationships with proven histories of positive returns went unrewarded and at times, were severely punished. Although returns generally were negative, many quantitative managers did not suffer the extreme performance problems of many of the multi-asset class managers and brokerage houses during the third quarter of 2007. Volatility increased substantially during the beginning of August, but absolute performance for the S&P 500 for the entire month was positive. The market nearly entered “correction” territory with the S&P 500 down approximately 9.5% (on a price basis) between July 19th and August 15th. But a significant performance recovery ensued through the end of September and beyond.

In general, managers focused on valuation and quality underperformed. Although a 2% positive return for the third quarter does not hint at the day-to-day story of the quarter, it demonstrates the end result was most investors finished the quarter at close to where they began.

While market sensationalism forces us to be aware of and to respond to the whims of the popular press, the long-term view returns us to where we began. In particular, any short-term period should be viewed in terms of historical context. These short-term periods historically have been followed by strong “bounce-backs” in portfolio return versus passive benchmarks.

► CONCLUSION

A structured equity strategy is distinguished by the belief that disciplined stock-selection coupled with a high level of risk controls can add value to a passive benchmark. A universe of structured equity managers benchmarked against the S&P 500 has outperformed fundamental managers by more than 70 basis points on an annualized basis during the 14 years, ending June 30, 2007, the longest time period available with significant data from the eVestment Alliance universe.

It is important to consider short-term performance returns for what they are – short term. Furthermore, the corresponding effect on long-term results generally is not meaningful. Long and intermediate term results support the inclusion of structured equity managers to enhance plan results and minimize non-compensated risk.

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