

An Update on the Environment for Active Managers

November 2008



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Overview of Active Management Environment

- Across the board, active investment managers are substantially lagging their benchmarks during 2008.
- It is important to note recent performance is by no means unprecedented or indicative of a sudden failure of active management.
- Generally speaking active managers tend to underperform during times of heightened market volatility or periods of irrationality.
- Active managers are charged with generating superior long term returns, a practice which often comes at the expense of short term underperformance.
- This is because allocating assets to capture both long and short term market conditions simultaneously is effectively an impossible task during times of market dislocations.
- Therefore, investors must be willing to bear short term underperformance to reap the long term rewards of active management.
- To this end, this presentation will examine the following aspects of active management:
 - Short and long term benchmark relative performance for institutional and retail manager universes
 - An illustration of recent market volatility at the sector level
 - Manager alpha over rolling periods for several asset classes
 - How credit market conditions serve as a risk factor for fixed income managers



Current Headwind Facing Active Management

- By definition, we hire active investment managers to employ a rational, long term investment discipline.
- However during times of not only excessive volatility, but panicked investor behavior, rational long term investment strategies rarely outperform.
- As such, we are unsurprised by the aggregate performance of active managers.
- Key observations:
 - In the aggregate, well over half of active managers have failed to beat their benchmarks during the 3rd quarter and year to date.
 - US small and fixed income managers have been hit the worst.
 - Longer term (10 year) performance remains solid for purely institutional managers (eVestment Alliance), whereas it is mixed when examining institutional and retail managers (Morningstar).

25% or less
26% - 50%
51% - 75%
76% - 100%

3Q'08 % of Active Managers Beating Benchmark (9/30/08)

Asset Class	Benchmark	eA	Morningstar
US Large Core Equity	Russell 1000	50	39
US Large Value Equity	Russell 1000 Value	32	33
US Large Growth Equity	Russell 1000 Growth	47	38
US Small Core Equity	Russell 2000	14	22
US Small Value Equity	Russell 2000 Value	8	13
US Small Growth Equity	Russell 2000 Growth	28	33
US Core Plus Fixed Income	LB Aggregate	11	25
International Equity	MSCI EAFE	42	43

YTD % of Active Managers Beating Benchmark (as of 9/30/08)

Asset Class	Benchmark	eA	Morningstar
US Large Core Equity	Russell 1000	62	37
US Large Value Equity	Russell 1000 Value	57	42
US Large Growth Equity	Russell 1000 Growth	45	30
US Small Core Equity	Russell 2000	23	25
US Small Value Equity	Russell 2000 Value	18	16
US Small Growth Equity	Russell 2000 Growth	18	25
US Core Plus Fixed Income	LB Aggregate	13	25
International Equity	MSCI EAFE	50	41

10 Year % of Active Managers Beating Benchmark (as of 9/30/08)

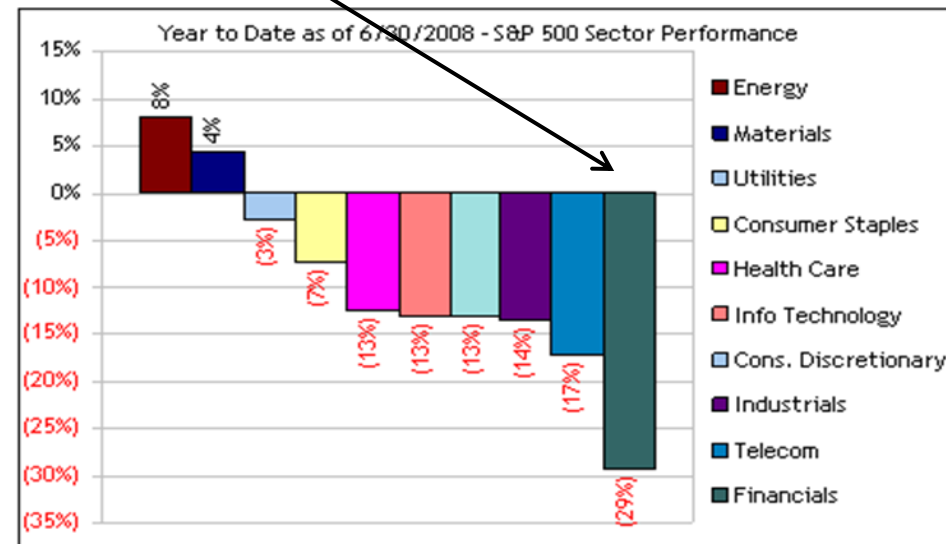
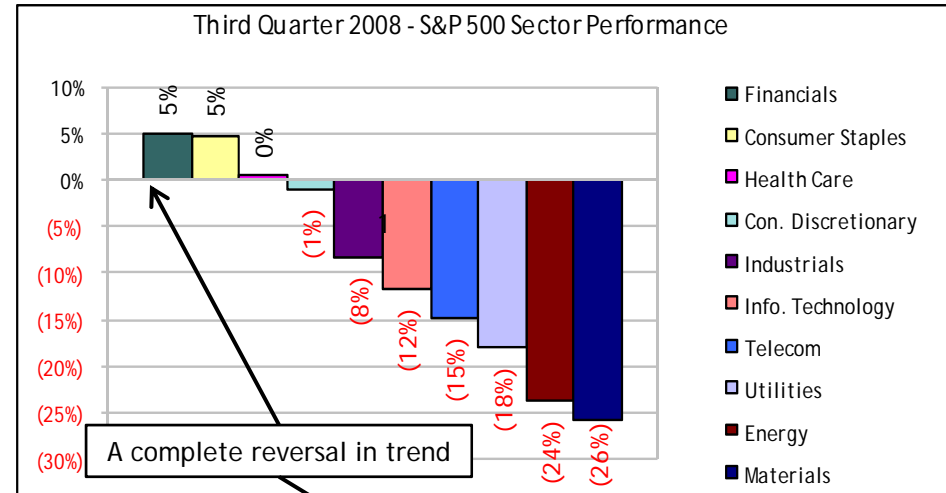
Asset Class	Benchmark	eA	Morningstar
US Large Core Equity	Russell 1000	82	46
US Large Value Equity	Russell 1000 Value	73	31
US Large Growth Equity	Russell 1000 Growth	96	79
US Small Core Equity	Russell 2000	83	60
US Small Value Equity	Russell 2000 Value	79	46
US Small Growth Equity	Russell 2000 Growth	90	79
US Core Plus Fixed Income	LB Aggregate	60	13
International Equity	MSCI EAFE	87	51

Source: Universe ranks from eVestment Alliance (gross of fees) and Morningstar (net of fees)



Timing Volatile Markets...An Impossible Task

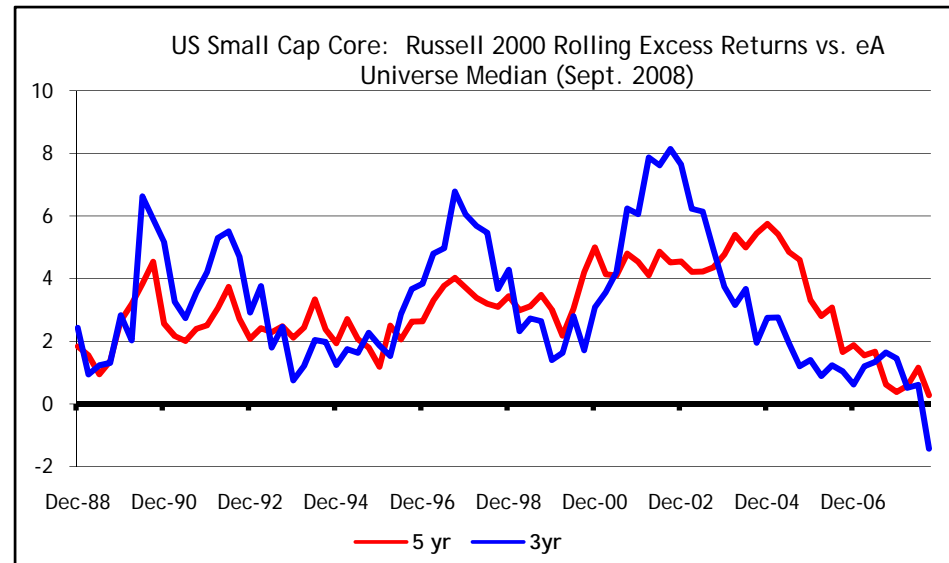
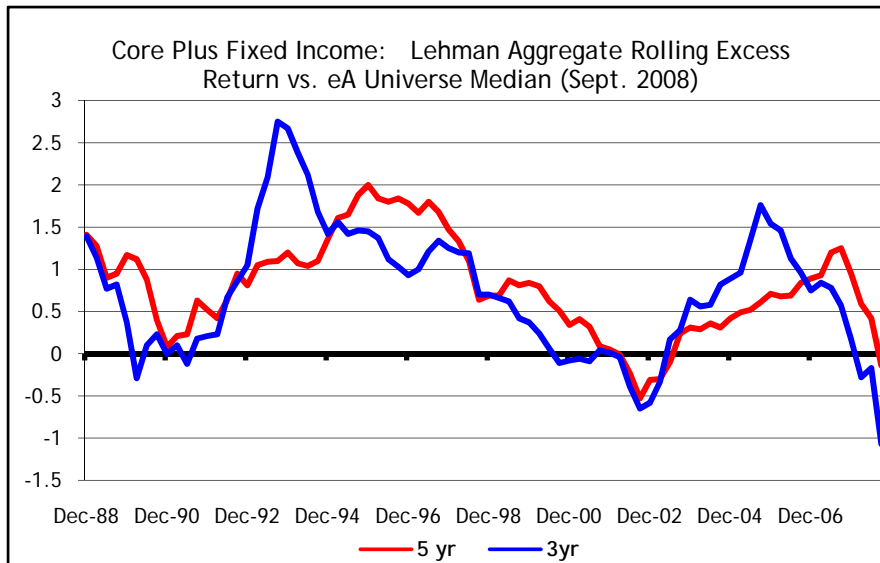
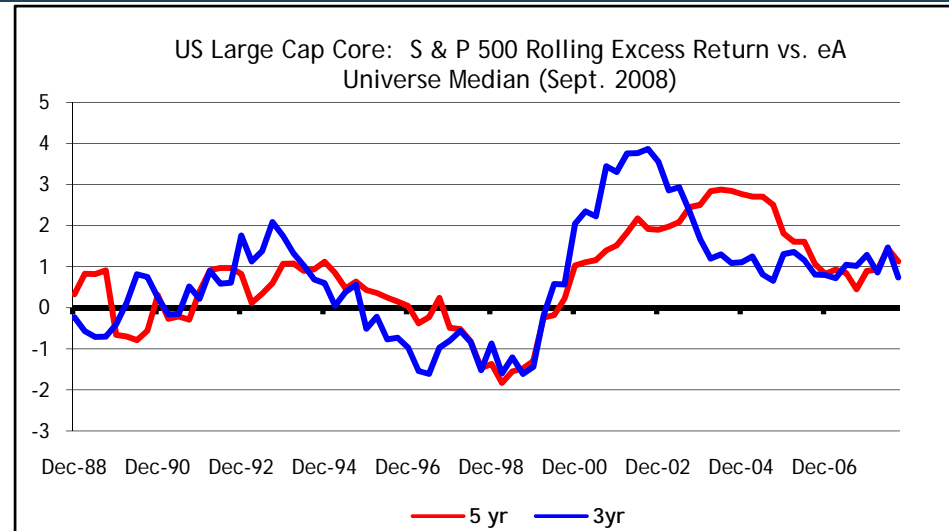
- Managers are tasked with dynamically re-positioning portfolio holdings in response to rapidly changing conditions in capital markets and the underlying economic environment.
- The focus of course is on the long, not the short term.
- Over time this is what we want active managers to do, but must understand decisions made with a long term time horizon do not necessarily result in short term outperformance.
- In fact they often do not, most notably during times of heightened sector volatility, making it nearly impossible for active managers to choose winning sectors ex-ante (or ahead of time).
- To illustrate this point, consider the volatility in sector returns and trends thereof just during the 3rd quarter 2008.
- Most notably we saw a complete reversal in the performance of financial stocks, having been the worst performer YTD through June, only to rebound strongly in the 3rd quarter.
- Utilities and energy stocks also saw a strong reversal in trend over the 3rd quarter.



Source: Investment Consultants Cooperative

Investors Must Keep in Mind "Alpha" is Cyclical

- Regardless of which asset class is in question, benchmark relative excess returns are volatile in nature.
- Over periods as long as rolling 3- and 5-years, excess returns are highly volatile for the median active manager in several asset classes.
- Furthermore, it is not uncommon to see active managers substantially underperform their benchmarks as a whole over long periods of time.
- For example, US large stock managers widely underperformed during the ending days of the tech bubble.
- Most recently US core fixed income managers are suffering due to a dislocation in credit markets.
- US small equity managers appear to have fared better over time, but survivorship bias in this asset class is significant.

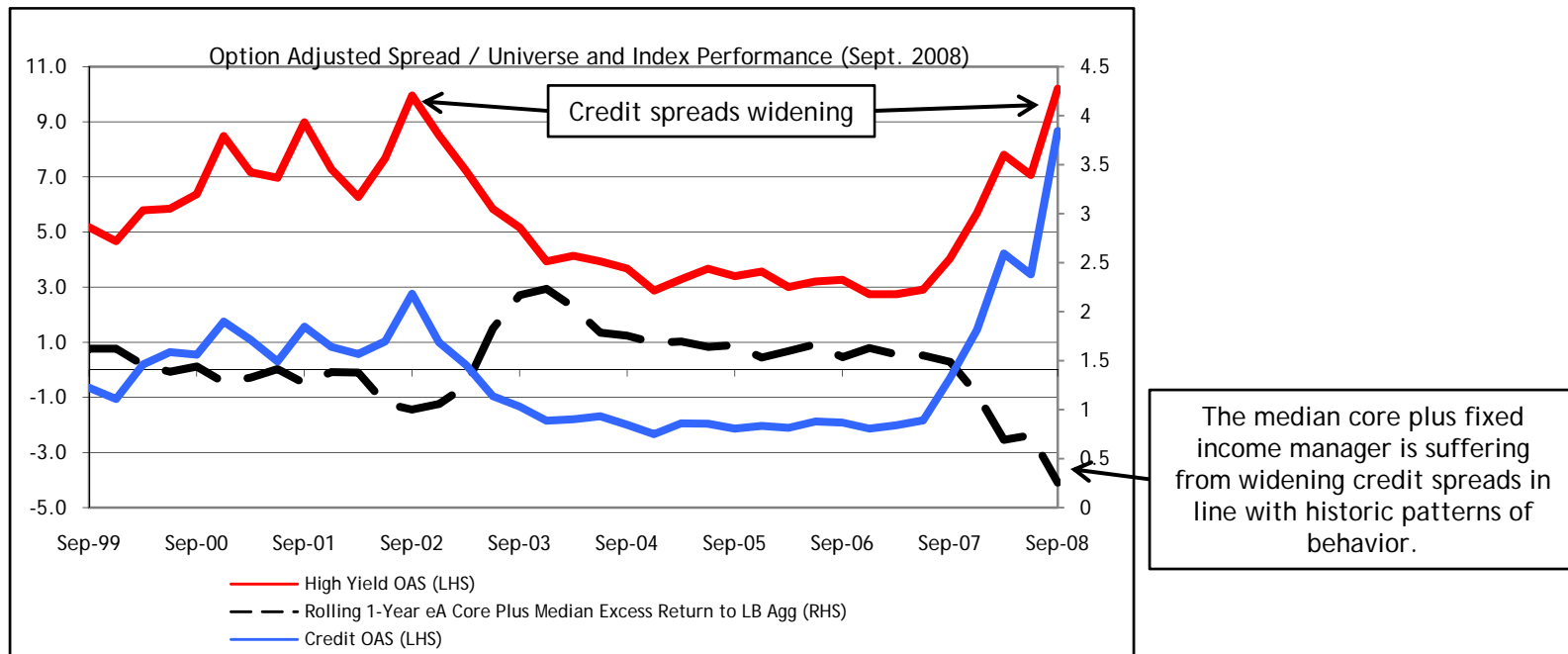


Source: eVestment Alliance (gross of fees)



Widening Spreads Caught Fixed Income Managers by Surprise

- Similar to long term trends in capital markets, certain risk factors have been known to affect active management returns.
- Most notable in the current market environment is the impact of widening credit spreads on the median core plus fixed income manager.
- If you examine this universe of managers over time you will find they are relatively sensitive to changes in credit markets.
 - Narrowing spreads = outperformance
 - Widening spreads = underperformance
- We would expect core plus fixed income managers to outperform the Lehman Aggregate benchmark when credit spreads begin to narrow once again.



Source: eVestment Alliance (gross of fees), Lehman Brothers

