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INVESTMENT PARTNERS

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The Value of Active Management

In the aftermath of the credit crisis and extreme price volatility, some investors have questioned the merits of active management, wondering whether they would be better off in passive index funds (or passive exchange traded funds-"ETFs"). Passive assets have grown substantially in recent years and now represent approximately $1.7 trillion USD, or about 22% of the total mutual fund industry in the United States, as of year-end 2009.[1]

As the active vs. passive debate continues and valid arguments are made from proponents of both approaches, we believe this is not necessarily a "one or the other" decision. Some of our largest institutional clients use a combination of active and passive management strategies. The rationale for passive management tends to focus on the efficiency that these products provide when it comes to achieving broad market exposure and in managing market risk. At the same time, we believe the rationale for active management, which provides a chance for outperformance and greater compounding of investment capital over time, is just as compelling, but perhaps not as well communicated.

In this issue of *The Focus,* we show how active management provides investors the opportunity to pursue outperformance, assuming that they can identify alpha-generating managers and have the discipline to stick with those managers during periods of underperformance.

Alpha and Beta

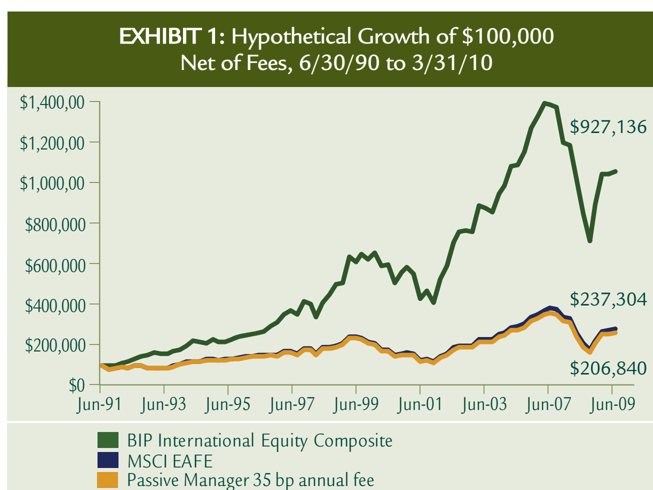
Generally speaking, alpha measures the amount of a portfolio's volatility-adjusted return against the benchmark's return. Positive alpha indicates the extent to which a manager has outperformed the market on a volatility-adjusted basis, while negative alpha indicates the extent of underperformance.

Beta compares only the volatility of a portfolio's returns with the volatility of the benchmark. A beta less than 1.0 indicates that a portfolio has displayed less volatility than the benchmark, while a beta greater than 1.0 indicates it has displayed more volatility.

Passive investing (including many types of ETFs) provides returns similar to a benchmark and often is referred to as achieving "market-like" returns. Returns for active managers include market returns plus the positive or negative alpha they generate. While both active and passive managers charge fees for their services, passive fees tend to be lower. Active managers seek to deliver better than benchmark long-term returns after fees. As many research reports have shown, the average active manager often tends to underperform the benchmark, and even the best managers often underperform in the short term.

Similarly, passive managers who seek to mirror benchmark returns likely will deliver *lower* than benchmark returns due to fees. Of the two approaches, active management provides the only potential for outperformance after fees.

Exhibit 1 shows an example of the compounded difference between active and passive management. In this example, active management, represented by the Brandes International Equity Composite, generated $664,652 in excess wealth vs. the benchmark and $720,296 vs. a passive manager over nearly 20 years.



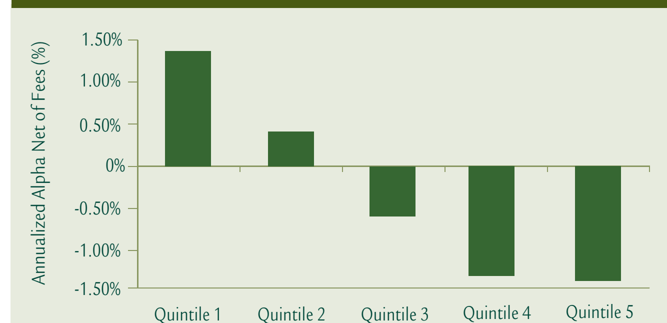
Source: Brandes Investment Partners, MSCI via FactSet, as of 3/31/10
This hypothetical example is intended for illustrative purposes only. Actual results will vary. This performance information is supplemental to the accompanying International Equity composite handout.
Past performance is not a guarantee of future results.

[1] Morris, Sonya. "Passive Funds Continue to Take Market Share." www.morningstar.com. 3/4/10.

Simulated results for the ETF were calculated by subtracting an annual management fee of 35 basis points each year from the index return.

The pursuit of alpha demands active management. Generating alpha consistently is not easy. However, managers who deliver alpha over the long term can provide investors with outperformance that can compound into a meaningful difference over the market return over time.

EXHIBIT 2: Annualized Alpha, Net of Fees Based on Level of Active Share (1980-2003)



Source: Cremers, Martijn and Antii Petajisto. "How Active is Your Fund Manager? A New Measure That Predicts Performance." October 3, 2006.
Past performance is not a guarantee of future results.

Identifying Alpha-Producing Managers

"To beat the benchmark, you have to be willing to look *different* than the benchmark." This is a common saying in the investment industry – and it makes sense. We believe one of the main reasons the majority of active managers tend to underperform their benchmarks is that many of them build portfolios that closely resemble the indices they are trying to beat. Once fees and trading costs are deducted, the average active manager naturally underperforms. So how can investors tell which managers look like the benchmark and which are truly active?

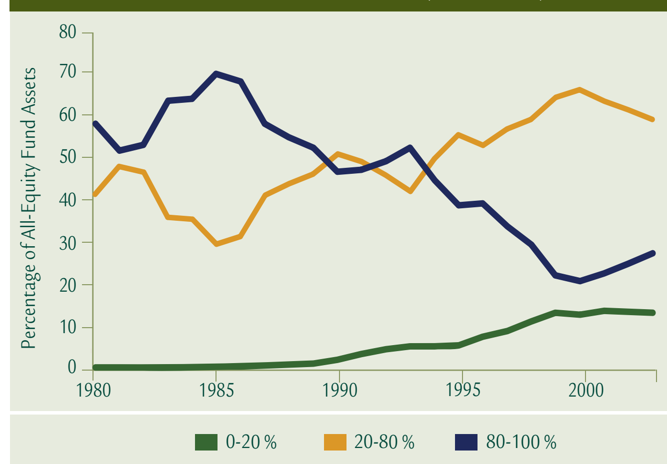
Yale professors Martijn Cremers and Antii Petajisto introduced the concept of "Active Share" in their 2006 study "How Active is Your Fund Manager? A New Measure that Predicts Performance."[2] Active Share measures the degree of overlap in holdings between a manager and the benchmark. An Active Share of 100% implies no overlap with the benchmark while passive index funds have an Active Share closer to 0%.

Cremers and Petajisto showed that U.S. managers with high Active Share have tended to significantly outperform their benchmarks, net of fees, over the long term. From 1980 to 2003, U.S. equity managers that ranked in the top 20% (or in Quintile 1) in terms of Active Share added approximately 1.4% in annualized alpha. See Exhibit 2.

What does this mean for an investor? An investment in the S&P 500 Index from 1980 to 2003 would have allowed a hypothetical $100,000 investment increase to more than $215,521. However, the 1.4% annualized alpha from a Quintile 1 manager would have grown the same hypothetical $100,000 investment to more than $300,885 – a difference of more than $85,000.

Using the Active Share measure, Exhibit 3 illustrates the evolution of the U.S. mutual fund industry. We segment "truly active" managers as those with Active Share above 80%. Conversely, we define "passive" managers as those with Active Share below 20%. Measured as a percentage of all-equity mutual fund assets, note the trends – the rise in passively managed assets and the decline in truly active stock picking.

EXHIBIT 3: Percentage of All-Equity Mutual Fund Assets Based on Level of Active Share (1980-2003)



Source: Cremers, Martijn and Antii Petajisto. "How Active is Your Fund Manager? A New Measure That Predicts Performance." October 3, 2006.
Data as of 12/31/03.

[2] Cremers, Martijn and Antii Petajisto. "How Active is Your Fund Manager? A New Measure That Predicts Performance." October 3, 2006.

How Active is Brandes?

Over our 35-year history as Graham & Dodd value managers we have made independent investment decisions resulting in portfolios that tend to look different from their benchmarks. Exhibit 4 illustrates the high Active Share characteristics for various Brandes portfolios. With an Active Share above 80 for each of these products, we believe they are well positioned to build on our history of alpha generation for our clients.

EXHIBIT 4: Active Share for Brandes Portfolios, as of 3/31/10

Portfolio	Benchmark	Active Share
Brandes Global Equity	MSCI World	84.6%
Brandes Global Equity	MSCI ACWI	86.6%
Brandes International Equity	MSCI EAFE	84.8%
Brandes International Equity	MSCI ACWI ex-US	88.9%
Brandes Emerging Markets Equity	MSCI EM	96.4%

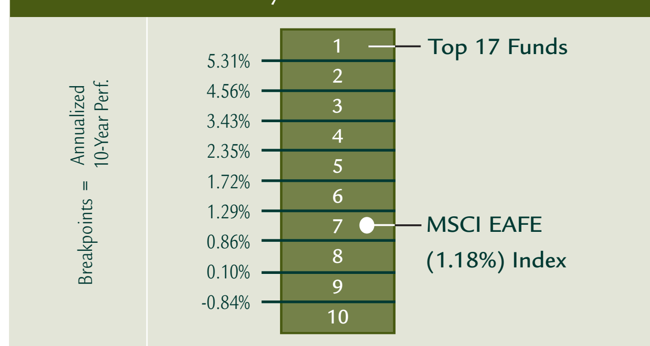
Source: Brandes Investment Partners, FactSet, as of 3/31/10
The portfolio characteristics shown relate to a single account from each listed product as of date noted, deemed by Brandes to be generally representative of its standard account noted. Not every account will have these exact characteristics. The actual characteristics with respect to any particular account will vary based on a number of factors including but not limited to: (i) the size of the account; (ii) investment restrictions applicable to the account, if any; and (iii) market exigencies at the time of investment. Portfolio holdings are subject to change at any time at the discretion of the investment manager.

Tools such as Active Share may help investors identify truly active managers – those who do not mirror the benchmarks they are trying to beat, and therefore may have a greater probability of long-term alpha generation. Of course, Active Share should complement a comprehensive evaluation of an active manager's investment philosophy, process, people, culture, infrastructure, and long-term performance.

Sticking With Active Managers

Identifying an active manager with the capability of generating long-term alpha is not enough to realize outperformance. An investor needs to demonstrate the discipline to stick with this manager through the inevitable periods of underperformance versus peers and the benchmark. A series of studies by the Brandes Institute titled "Death, Taxes and Short-Term Underperformance" shows that top-performing international equity mutual funds have added considerable value over the MSCI EAFE Index during a recent 10-year stretch. The 17 funds in the top decile of this study produced annualized returns of at least 5.3% vs. 1.2% for the benchmark (a difference of 4.1% each year), as shown in Exhibit 5.

EXHIBIT 5: International Funds Ranked by 10-Year Performance



Source: Morningstar, The Brandes Institute; as of 6/30/09
Past performance is not a guarantee of future results.

However, when looking at their shorter-term results during this 10-year period, nearly all of these top performers endured periods of extended under-performance, illustrated by their lower decile appearances over rolling 1-year and 3-year periods. See Exhibit 6 (on following page).

As the Brandes Institute studies illustrate, active managers who have a long-term track record of outperformance tend to go through down periods which might cause them to fall out of favor. This is an inherent element of active investing, as the markets can be irrational or unpredictable in the short term. It is precisely during these bad times that we believe investors need to remain disciplined, and not lose confidence in the managers they have identified as alpha generators.

Tying this need for patience to the Active Share tool, the average Active Share for the top 17 funds was 90.4%.

Often, investors tend to be their own worst enemies. According to Dalbar, for the 20 years ended 2008, the S&P 500 Index earned 8.4%, but the average equity fund investor earned only 1.9% (more than four times less

EXHIBIT 6: Top 17 Non-U.S. Funds: Appearance in Lower Deciles, June 1999 – June 2009

	Of top 17 funds, # with at least one appearance at or below...				
	Decile 6	Decile 7	Decile 8	Decile 9	Decile 10
Based On Quarterly Performance	17	17	17	17	17
Based On Annualized 1-Year Performance	17	16	15	15	11
Based On Annualized 3-Year Performance	14	12	9	7	5

Source: Morningstar, The Brandes Institute; as of 06/30/09.
Past performance is not a guarantee of future results.

than the index).[3] The "average" investor returns were calculated based on flows. And investors tended to time their purchases based on short-term performance. They panicked and sold when their funds were doing poorly – and invested when the funds were doing well.

Investors in passive funds or ETFs are not immune from the tendency to "chase" short-term results, according to research by the Vanguard Group, a leading provider of index funds. On a simple average basis, ETFs in a Vanguard study delivered a 1% compounding return over the trailing five years, translating into a cumulative gain of 6%. Investors, however, earned a -3.5% average compounding return, translating into a cumulative *loss* of 12%. Vanguard founder John Bogle said during a webcast in 2009, "So we have evidence, strong evidence, that exchange-traded funds, because of the timing that goes on in them, are not acting in the best interest of investors. Or, that investors are not acting in their own best interests, which may be a better way to put it."[4] Whether choosing an active or passive manager, maintaining a long-term focus has proven critical to long-term success.

Final Thoughts

Of course alpha has the potential to compound wealth at levels far above benchmark returns – provided investors stay invested. There are additional benefits to active management that should not be overlooked:

- A combination of active managers, within the same asset class, can provide alpha while potentially reducing volatility, compared to the benchmark.
- We believe the explosive rise in passive indexing recently has made markets less efficient and potentially more attractive for active managers. The more money that is moving into and out of securities based solely on their size (often the driving factor in index fund flows), the more valuations become distorted, creating opportunities for active managers.
- From our perspective, there is currently a great deal of value in the markets, and a wide divergence of valuations within each sector. Historically, this has boded well for active value investors.

When it comes to trying to select above-average active managers, it always has been important to evaluate long-term track records, the process and philosophy used to generate those track records, and whether the approach offers an opportunity for future success. In addition to evaluating a manager's people, culture, and infrastructure, recently introduced tools such as Active Share also may help in identifying truly active managers – managers who do not look like the benchmark, and therefore may have a greater probability of long-term alpha generation.

Benjamin Graham, wrote that to "enjoy a reasonable chance for continued better than average results, the investor must follow policies which are inherently sound and promising and are not popular in Wall Street."[5] We believe that consistently buying securities at discounts to our estimates of their intrinsic values has proven its merit. And our global search for undervalued securities tends to drive us toward out-of-favor areas that often are, "not popular."

We believe our firm has demonstrated the skill and mettle necessary to implement a strict, active, value investing approach – and that active value investing remains the best way to build long-term wealth.

[3]Dalbar Inc., *Quantitative Analysis of Investor Behavior,* March 2009.

[4]Hougan, Matt. "Bogle: Investors Are Getting Killed in ETFs." www.indexuniverse.com. 6/17/09.

[5]Graham, Benjamin. *The Intelligent Investor: A Book of Practical Counsel,* 4th rev. ed., New York: Harper & Row, 1973, p. 13.

Alpha - A portfolio's alpha measures the difference between its actual returns and its expected returns given its risk level as measured by its beta. A positive alpha indicates the portfolio has performed better than its beta would predict, while a negative alpha indicates a portfolio has underperformed given the expectations established by its beta.

Beta - A stock's (or a portfolio's) beta measures its volatility versus an index. A stock (or portfolio) with a beta higher than one has tended to exhibit more volatility than the index, while a stock (or portfolio) with a beta between zero and one has tended to exhibit less volatility than the index.

MSCI EAFE Index - MSCI EAFE - The MSCI EAFE (Europe, Australasia, Far East) Index with net dividends is an unmanaged, free float-adjusted market capitalization weighted index designed to measure equity market performance of developed markets, excluding the United States and Canada. This index often is used as a benchmark for international equity portfolios and includes dividends and distributions net of withholding taxes, but does not reflect fees, brokerage commissions, or other expenses of investing.

S&P 500 - SP500 G - The S&P 500 Index with gross dividends is an unmanaged, market capitalization weighted index that measures the equity performance of 500 leading companies in leading industries of the U.S. economy. Although the index focuses on the large cap segment of the market, with approximately 75% coverage of U.S. equities, it can also be a suitable proxy for the total market. This index includes dividends and distributions, but does not reflect fees, brokerage commissions, withholding taxes, or other expenses of investing.

MSCI World Index - MSCI WRLD - The MSCI World Index with net dividends is an unmanaged, free float-adjusted market capitalization weighted index that is designed to measure equity market performance of the developed markets throughout the world, including the United States. This index includes dividends and distributions net of withholding taxes, but does not reflect fees, brokerage commissions, or other expenses of investing.

MSCI Emerging Markets (MSCI EM) Index - MSCIEMF - The MSCI Emerging Markets Index with gross dividends is an unmanaged, free float-adjusted market capitalization weighted index designed to measure equity market performance in emerging markets throughout the world. This index includes dividends and distributions, but does not reflect fees, brokerage commissions, withholding taxes, or other expenses of investing.

MSCI All Country World (ACWI) Index - MSACWFREE - The MSCI All Country World (ACWI) Index with gross dividends is an unmanaged, free float-adjusted market capitalization weighted index designed to measure equity market performance of developed and emerging markets, including the United States. This index includes dividends and distributions, but does not reflect fees, brokerage commissions, withholding taxes, or other expenses of investing.

MSCI All Country World ex-U.S. (ACWI ex-U.S.) Index - MSACWFXUS - The MSCI All Country World ex-U.S. (ACWI ex-US) Index with gross dividends is an unmanaged, free float-adjusted market capitalization weighted index designed to measure equity market performance of developed and emerging markets, excluding the United States. This index includes dividends and distributions, but does not reflect fees, brokerage commissions, withholding taxes, or other expenses of investing.

Past performance is not a guarantee of future results.

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