

# Sourcing Alpha

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July 2011

from  Montage Investments

## A Six Month Market Cycle

From January 1st until the end of April, the Russell 3000 had risen 9.1%, and the Russell 2000 advanced 10.8%. Companies that reported solid earnings growth driven by top line sales growth were rewarded with positive relative stock performance. Optimism abounded. Then came May.

Just as in 2010, the summer doldrums meant a return to concerns about Greece and debt accumulation across the globe. From May 1st until June 24rd, the large cap market had retreated 7.16%. By the end of June, however, the market had nearly recovered everything it had lost.

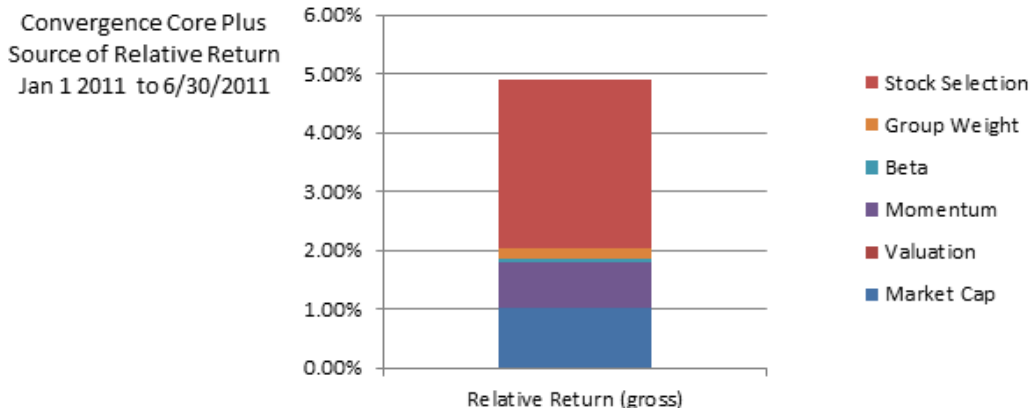
Welcome to the new market cycle.

## Opportunities Abound

Only 23% of large cap active stock fund managers beat the market in the first 6 months of 2011 according to Merrill Lynch. This is nearly identical to 2010 where only 20% won. The Convergence Core Plus Fund, however, beat the Russell 3000 in 2010 by 580 basis points, and has advanced ahead of the market so far this year by another 431 basis points. Against the Morningstar Large Cap Universe of managers, this places the Fund in the top 3% in 2010, and the top 3% so far in 2011. Even as managers struggle in the current environment, we have found it rich with opportunities.

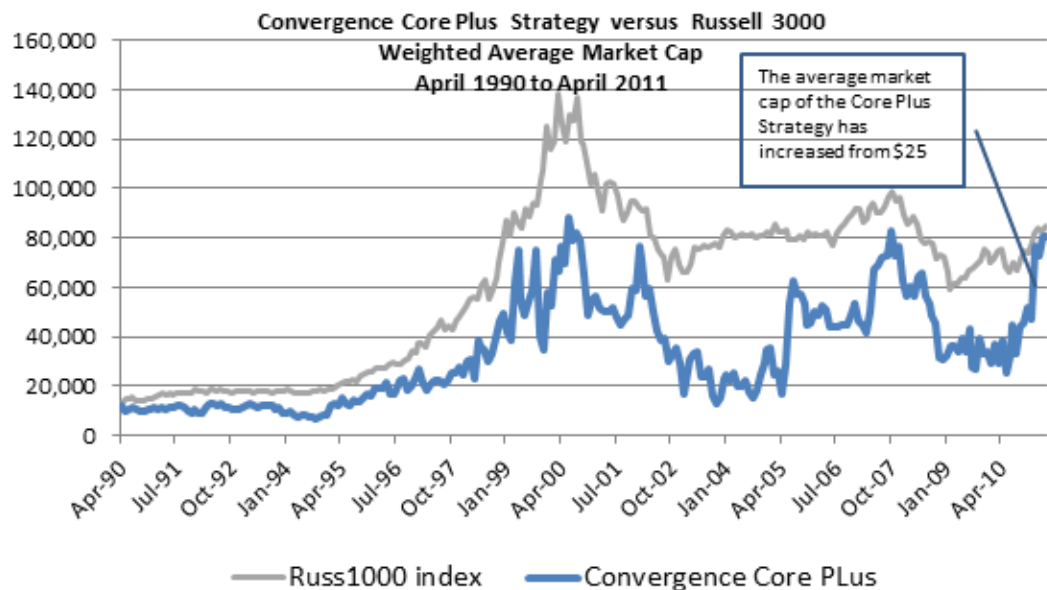
## The “Plus” is the Driver

Our investment process seeks out multiple sources of alpha through the use of our proprietary dynamic model, a broader mandate, and our ability to short. As we examine the sources of alpha over the past 6 months we see all of these in play. The chart below shows the sources of alpha on the total portfolio for the first six months. While “Stock Selection” comprised one half of the alpha in the first half, “Market Cap Tilt” and “Momentum” comprised the other half.



During the first 4 months of the year the market was rallying. Our stock picks, and our market cap tilt added a great deal of relative return to the market. The Core Plus Fund was up 13.9% versus 9.1% for the Russell 3000. When the market rolled over in May, our reduced exposure to more volatile stocks helped the portfolio hold up in the sell-off. In the May to June period the market was off 2.92% versus the Core Plus Fund at -2.86%.

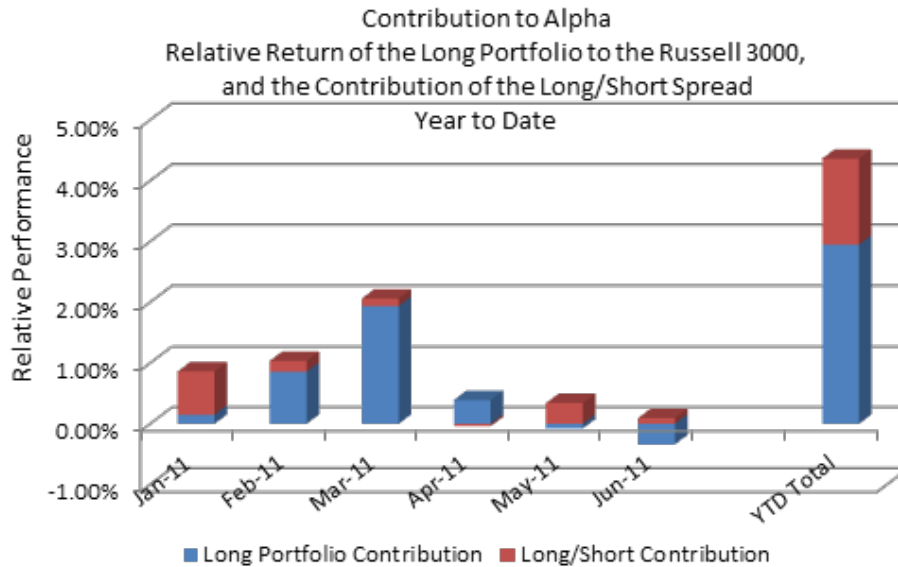
One of the key elements to producing the positive alpha in both the rally as well as the market correction was the significant shift in market cap of the portfolio. With small and mid cap stocks rallying ahead of large cap stocks since last summer, their relative valuations became extended. Measuring relative valuations as well as investor preferences, our Dynamic Model shifted the market cap of the portfolio to \$78 billion on June 30 versus the market at \$72 billion. This is up from just over \$20 billion last summer. With a larger market cap, and a lower implied risk, the portfolio was positioned to weather the storm.



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## Profiting from Uncertainty

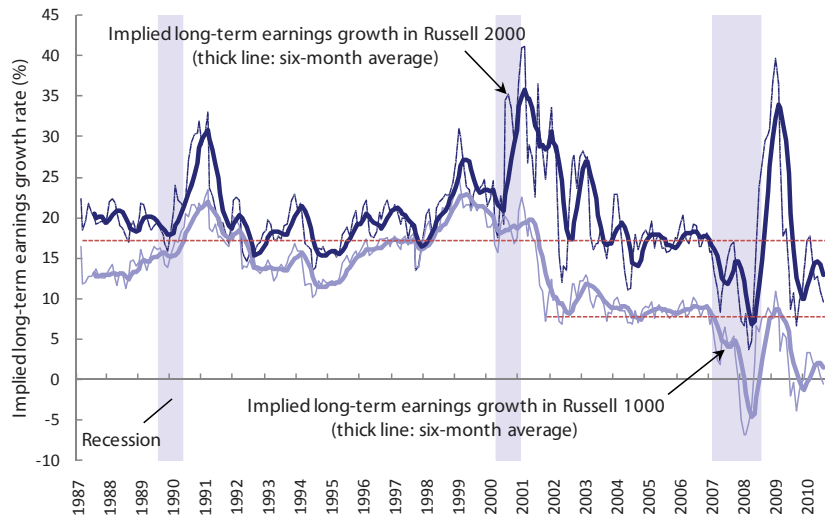
Market Volatility generally provides an opportunity to benefit from shorting, and 2011 has provided that opportunity. During the first six months of 2011 nearly one third of our relative return is attributed to the spread we drove between our short positions and our long positions. Importantly, during the months of May and June, as the market corrected and our long portfolio struggled to match the returns of the market, our long/short spread added 43 basis points to performance, once again underscoring the benefits of looking to multiple sources of alpha.



## A Positive View of What Lies Ahead

The longer the list of negatives, the more positive one should become. The current list is long.

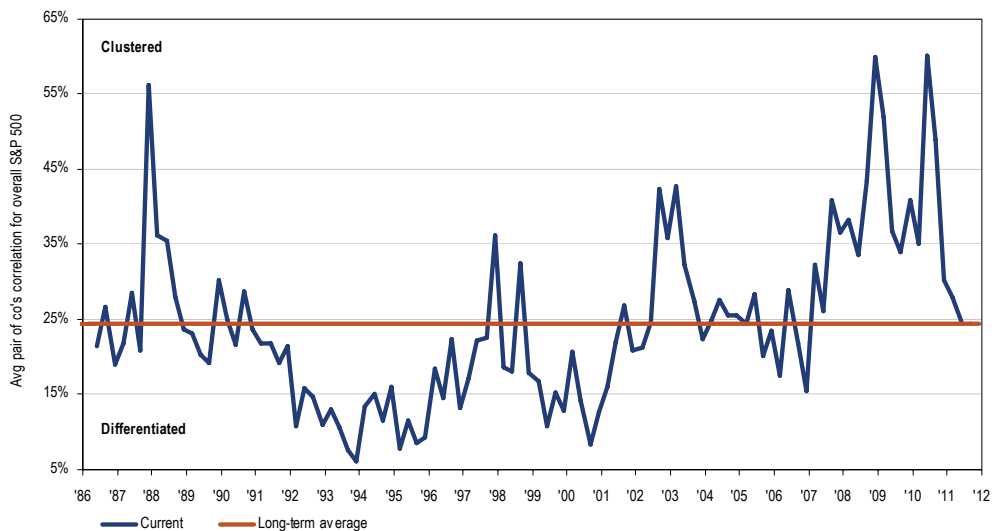
Nowhere is the impact of the clouds hanging over the market more evident than if one looks at the implied growth rate built into market prices. Today the market outlook for long-term earnings growth in large cap stocks is zero. The implied growth rate for small cap stocks is just 10%, near a 30 year low. With such low expectations, the upside potential is in our view certainly material.



Notes: Shows the implied long-term earnings growth rate and its six-month average for the Russell 1000 and Russell 2000. Implied long-term earnings growth rate (from FY1 to FY5) is derived by assuming a static risk premium, 2.8% for the Russell 1000 and 2.7% for the Russell 2000, which are historical averages of the implied risk premium based on a residual income model and I/B/E/S forecasted earnings. Last data points are as of 3 June 2011.  
 Source: Nomura Securities International, Inc., I/B/E/S, Russell, Compustat, IDC.

Finally, the slow return to what we would characterize as more traditional market is positive for active management in general, and has us very excited about the possibilities for the Convergence Strategy. As noted in the chart below, correlations between stocks are finally falling. During the 2008 to 2009 collapse, correlations shot up, leaving little room for active managers to create alpha. When everything is going in the same direction, at the same speed, there is scant opportunity to differentiate. With correlations now returning to more traditional levels, we see growing potential to identify and capture multiple sources of alpha. For our investment process, we believe that this is the best environment in which to operate.

### Pair-wise correlations of all S&P 500 stock combinations Daily returns per quarter (2Q 1986 to May 2011)



Source: BofA Merrill Lynch US Quantitative Strategy