

**Altura Capital Group, LLC
Asset Class Research Note**

February 2012

**US Equity Performance
by Size of Manager**



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Asset Class Report: US Equity

Summary

There are many studies showing that smaller managers perform better than their larger peers. We have produced three papers in the past few months that reviewed US Large Cap Equity, US Mid Cap Equity and US Small Cap Equity managers. These papers are available on the Altura website at <https://www.alturacap.com/industryresearch.php>. In this paper, we review and aggregate the data for US Equity managers across all sizes and all styles. Our previous studies show that a three year time frame appears to be too short to show clear trends, so in this study we focus on 5 year time periods. In previous studies, we also show that categorizing firms by size on an ex-ante (at the beginning of the performance period) versus ex-post (at the end of the performance period) basis produces results that would be more relevant to an investor, who is not going to have access to ex-post information. Therefore, in this study, we categorize managers into size buckets by ex-ante assets under management.

1. Many studies have shown that smaller managers tend to perform better than larger managers. In this paper, based on longer-term 5 year data, we show that:
 - a. There are better than even odds (15 out of 27 or 56%) that there is an excess return advantage to using smaller managers. During the 3 overlapping five-year periods we look at, this advantage is clear in the Value and Core styles across the market cap range. In the Mid Cap Growth segment, while active managers generally outperformed, there seemed to be an advantage to larger managers.
 - b. There are high odds (24 out of 27 or 89%) that an investor would be no worse off using smaller managers. It remains to be seen whether this positive result will continue to hold, and whether there is movement in the style and size segments where there is less advantage to using smaller managers.
2. We also show that smaller managers are more diverse in their returns, which means that due-diligence might have more opportunity to differentiate between managers. Smaller managers also show higher levels of tracking error, so a multi-manager portfolio may be required to achieve an implementation with which institutional investors are comfortable.

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Market Environment

5 Years Ending June 2011

	Value	Core	Growth
Large Cap	1.15	3.30	5.33
Mid Cap	6.28	5.30	4.01
Small Cap	2.24	4.08	5.79

In the chart above, we can see that returns, based on index performance¹ have been subdued over the five-year period ending 2011. The returns are strongest in the Growth style, and in Mid Cap segment. Value stocks have been depressed by the terrible performance of the financial sector during the market decline.

¹ Returns are annualized. The Large Cap style boxes show the returns for the Russell 1000 Value, Russell 1000 and Russell 1000 Growth indices. The Mid Cap style boxes show the returns for the Russell Mid Cap Value, Russell Mid Cap and Russell Mid Cap Growth indices. The Small Cap style boxes show the returns for the Russell 2000 Value, Russell 2000 and Russell 2000 Growth indices. The returns were calculated using the Morningstar Direct platform.

US Equity Data Set

There is a reasonable set of data² in each size and style category with 5-year returns. Based on previous research, we believe that the size of the firm at the start of the measurement period provides us with a better perspective on the potential benefits of investing in managers of a given size. The ex-ante measure of size allows insight into how smaller versus larger managers subsequently performed.

Data Definition by Manager Size Category

Size	Range in Firm AUM (billions)
Very Small	Less than \$2
Small	\$2 - \$10
Medium	\$10 - \$50
Large	\$50 - \$250
Giant	More than \$250

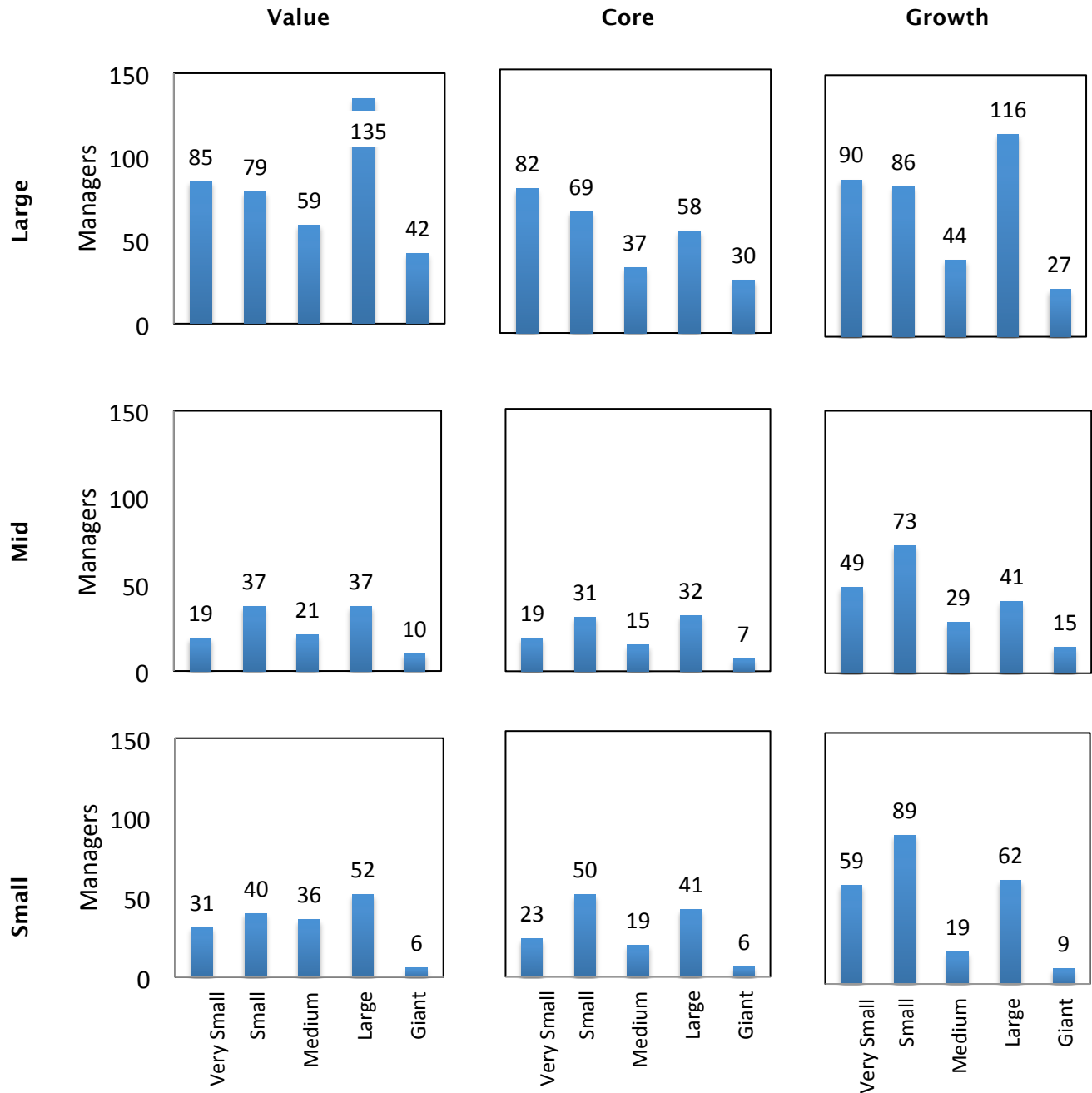
Data Count

As can be seen from the set of charts below we can draw the following conclusions:

1. There is a large set of Large Cap data. There is a moderate set of Mid Cap and Small Cap data, with Small Cap managers outnumbering Mid Cap managers slightly.
2. There are more Growth managers in every size segment than there are Core or Value managers.
3. There are very few Giant managers in the Small Cap and Mid Cap space.

² The data shows the number of firms that a) Have provided AUM data at the start of the measurement period b) have performance for the entire 5 year period and c) the AUM fits within a certain size category.

Data Count for US Equity Managers by Mandate Market Cap, Mandate Style and Size of Manager



Excess Return

We now look at the excess returns³ generated by managers⁴ depending on size⁵.

In the charts on the next page we see:

1. In all charts, the average outperformance for managers in that size classification, and with a product in that particular market cap and style segment is shown in the grey bars.
2. When smaller managers tend to outperform larger managers, the trend line is colored green. The trend line will slope downwards with increasing size by more than 100 basis points (bps) from the smallest to the largest category of manager.
3. When the trend is weaker, the trend line is colored black. The trend line will slope up or down by less than 100 bps from the smallest to the largest category of manager.
4. When the trend favors larger manager over smaller managers, the trend line is colored red. The trend line will slope upwards with increasing size by more than 100 bps from the smallest to the largest category of manager.

From the set of charts on the next page, we can draw the following conclusions by looking at the excess returns and their correlation to firm size.

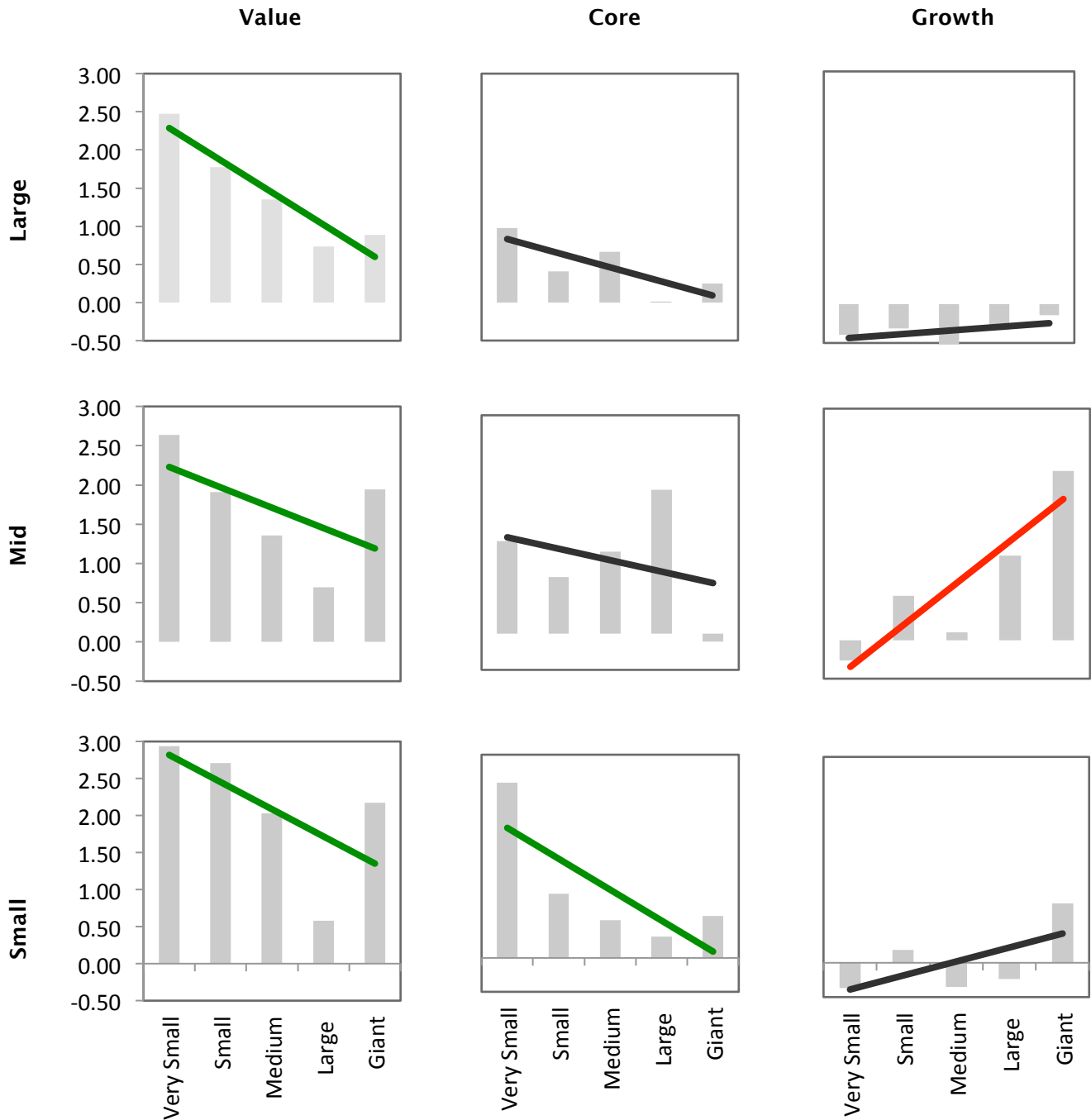
1. In four of the nine style/market cap categories, the trend is for smaller managers to add more value than larger managers. This is particularly true among value managers, regardless of market cap segment.
2. In four of the nine style/market cap categories, the trend is weaker, and no definitive conclusion can be drawn regarding the advantage or disadvantage of manager size on performance.
3. In one of the nine style/market cap categories (Mid Cap Growth), there appears to have been an advantage to larger managers in terms of adding value.
4. It should also be noted that active managers added the least excess return in the Growth style of products. It should also be noted that this is where small managers did not show any return advantage over their larger peers.

³ The excess return is defined as the difference between the annualized return for a product and the annualized return for the benchmark. The benchmarks are as previously defined. The excess return for the set is the return for every product that falls within a certain group and that has a full set of data for that time frame. For example, the excess return for the group of “Very Small” managers for the 5 yr 2001-2011 period is the arithmetic average of the 5-year returns for all managers that have returns ending 6/30/2011, and that have provided an “assets under management” number as of 6/30/2006 that puts them in the “Very Small” category.

⁴ All manager and product data for this study was extracted from the Morningstar Direct platform on October 12th, 2011. The data is based on the Morningstar Direct classification of size and style, and all data is from the Morningstar Direct separate account universe. Index Funds and ETFs were excluded from the search in order to limit the universe to actively managed products.

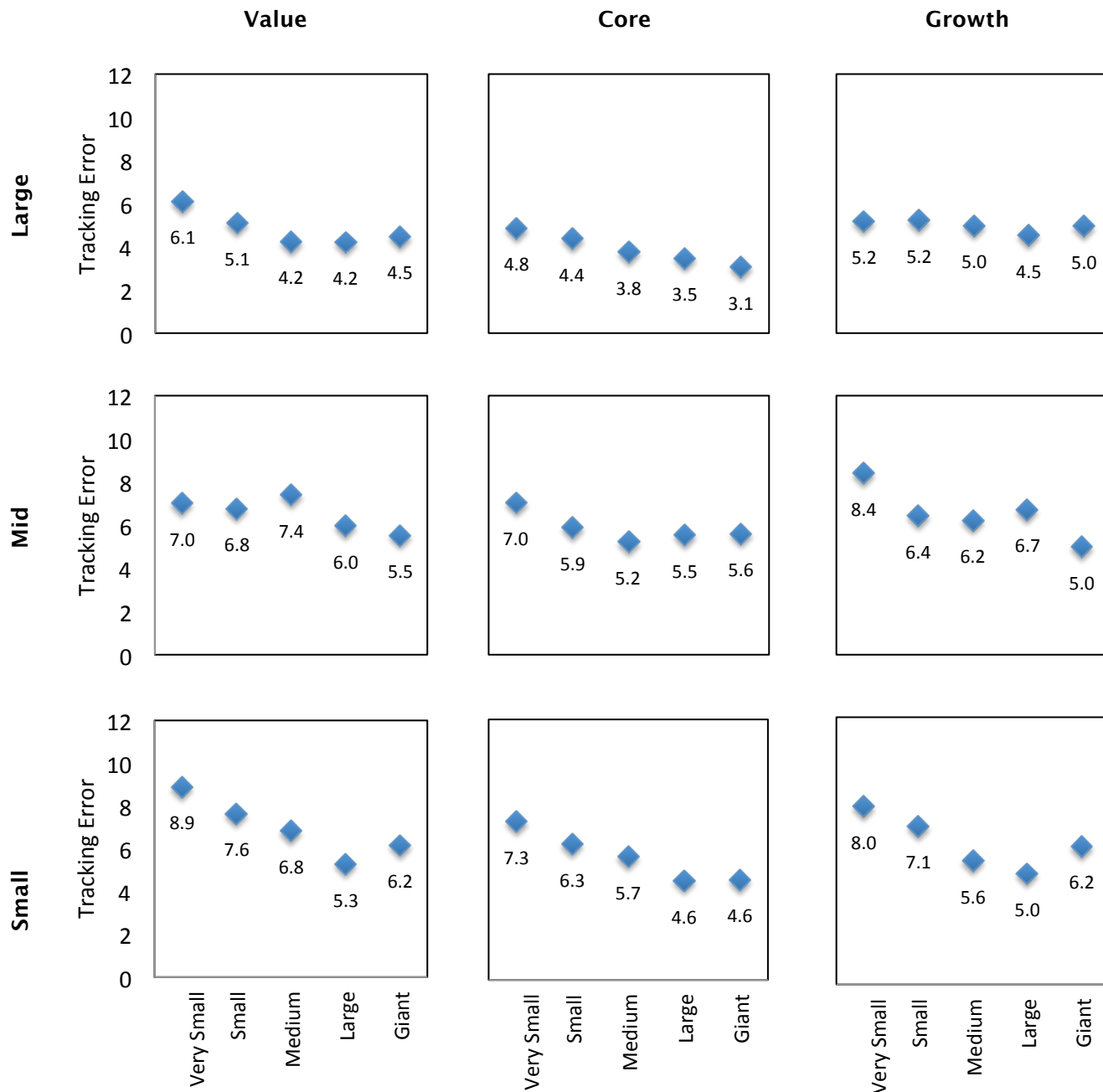
⁵ Size is defined by the total AUM (“assets under management”) of the firm. The firm must have provided AUM as of the starting date of the appropriate time period in order to be counted, and it must also have returns covering the appropriate time period. The categories are defined in the table.

Excess Return Trends for US Equity Managers by Mandate Market Cap, Mandate Style and Size of Manager for the 5 years ending June 30, 2011



Tracking Error

Average Tracking Error for US Equity Managers by Mandate Market Cap, Mandate Style and Size of Manager for the 5 years ending June 30, 2011



Of course, with any discussion of excess return, one must also consider risk, and while there are several ways of looking at risk, tracking error⁶ is one of the most utilized for larger institutional investors.

As can be seen from the chart above, smaller managers do generally display higher average tracking error, indicating the possibility of more concentrated portfolios, more style variance, more deviation from benchmark weights, or some combination of the above. Our qualitative research of managers does show that smaller firms tend to run more concentrated portfolios on average.

It is also worth noting that Large Cap products tend to have lower average tracking errors than Mid-Cap and Small Cap products, regardless of manager size.

⁶ Tracking error is calculated by the Morningstar Direct platform and is defined as the standard deviation of the differences between each product's monthly returns and the returns of the benchmark. The number is then annualized. The tracking error displayed is the simple arithmetic average for all products within a certain market cap and style segment, which is then further broken down by manager size.

Alternative measures of risk

There were two other measures of risk we looked at, the average risk for managers, as measured by standard deviation, and the spread, or standard deviation within a set of managers. Let us start by looking at the average risk.

5 Year Average Risk⁷ for US Equity Managers by Mandate Market Cap, Mandate Style and Manager Size as of June 30, 2011

	Value	Core	Growth	
Large Cap	Very Small	17.74	17.53	17.73
	Small	18.24	17.46	18.25
	Medium	18.62	17.67	18.40
	Large	18.43	17.80	18.76
	Giant	18.36	17.88	19.21
	Relevant Russell 1000 Index⁸		18.98	18.21
Mid Cap	Very Small	19.96	20.93	21.17
	Small	20.34	20.88	20.90
	Medium	22.38	21.69	20.61
	Large	20.74	19.75	20.89
	Giant	20.87	21.67	20.75
	Relevant Russell Mid Cap Index		21.96	21.42
Small Cap	Very Small	22.79	22.00	23.02
	Small	23.23	22.62	22.49
	Medium	23.07	22.24	21.86
	Large	22.79	22.05	22.93
	Giant	22.96	23.35	22.43
	Relevant Russell 2000 Index		23.26	22.76

⁷ The average risk is the arithmetic average of the standard deviation of each of the products in a given size category. It is a measure of the risk of the “average product” within a given size category.

⁸ The Relevant Index adjusts for the style. For example, the Relevant Russell 1000 Index for the Large Cap Value segment is the Russell 1000 Value Index. For the Core style the relevant index is the full benchmark, and for the Growth style the relevant index is the Growth style of the index.

When we look at the average risk, as measured by standard deviation in the table above, we can draw the following conclusions:

1. Small Caps have shown more risk than Mid Caps, which have shown more risk than Large Caps. This result is as expected, and should be comforting to most readers.
2. In every market cap segment, the Value style was the riskiest. In general core was the least risky and growth was a little bit riskier. This is not as expected, and certainly contrary to large numbers of observations. This time period stands out as one in which financials, which have a large weighting in Value indices, have experienced a very high level of volatility.
3. In general, active managers have had less risk than the benchmark. This is a heartening result because it makes the excess return more impressive, particularly for smaller managers.
4. In addition, smaller managers seem to have had lower levels of absolute risk than larger managers. In 6 of 7 instances when a group of managers had more risk than the benchmark, the managers were medium or larger in size.

*5 Year Product Spread⁹ for US Equity Managers by
Mandate Market Cap, Mandate Style and Manager Size as of June 30, 2011*

		Value	Core	Growth
Large Cap	Very Small	1.85	2.31	2.15
	Small	2.00	1.92	2.19
	Medium	1.92	1.50	2.53
	Large	2.22	1.72	1.94
	Giant	1.71	1.75	1.48
Mid Cap	Very Small	2.82	3.08	4.56
	Small	2.77	2.43	2.60
	Medium	2.32	1.79	2.66
	Large	3.18	1.94	2.28
	Giant	0.69	2.67	2.19
Small Cap	Very Small	2.79	3.46	3.82
	Small	2.94	2.93	3.40
	Medium	2.48	2.47	3.02
	Large	3.19	2.76	2.88
	Giant	2.01	1.85	3.46

We can draw several conclusions from the table above:

- In general, the larger the firm, the less differentiation exists among product returns, as shown by the product-spread table. This could be because smaller managers, who tend to be more concentrated, allow themselves to deviate more from the benchmark, and from each other.
- Products spreads are higher for Mid Cap and Small Cap than Large Cap products. Over this period, Growth products had a higher spread, which means that even though active managers, in aggregate had a harder time adding value, there were potentially rewards to be had from some active managers, even in those asset classes.

⁹ The product spread is the standard deviation of the annualized returns of the products within a certain size category. It measures the consistency of the results within a given size category. A high number indicates more variance between returns within the same size class.

Given the above, we believe that an investor may be well served hiring multiple smaller managers to reduce tracking error, AND, that intensive manager research should be able to differentiate between firms more substantially in the smaller manager space, given the larger spread between returns.

The next question we can ask ourselves is if the time period affected the results of our study. We therefore roll back the clock and look at the results for the periods ending June 2010 and then June 2009.

Five Years ending 2010

Market Environment

5 Years Ending June 2010

	Value	Core	Growth
Large Cap	-1.64	-0.56	0.38
Mid Cap	0.71	1.22	1.37
Small Cap	-0.51	0.37	1.14

If one looks at the five year returns ending June 30, 2010 in the chart above one can see that:

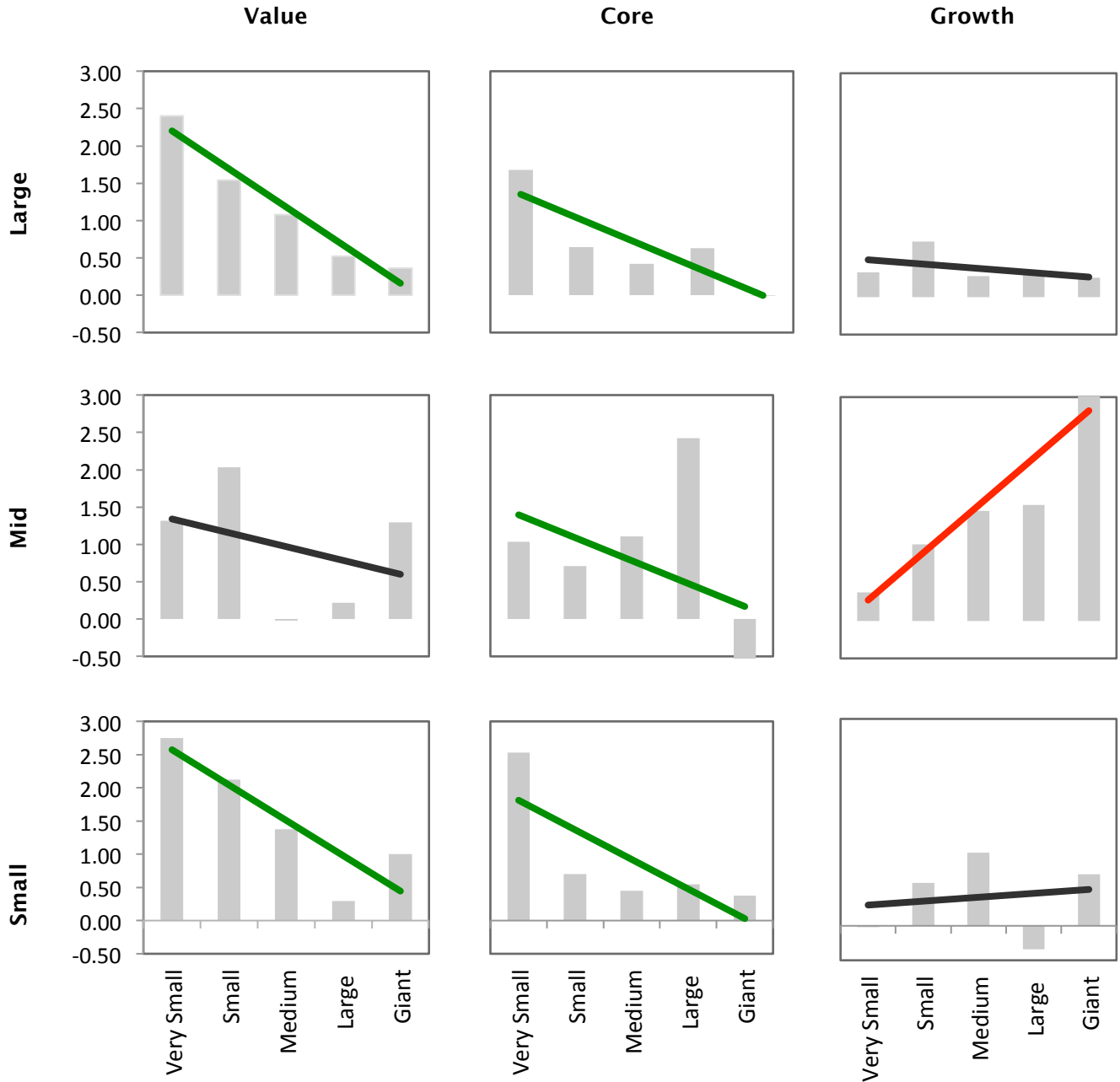
1. The returns for US stocks have been mediocre at best, with Value stocks showing significant underperformance across all market caps.
2. This return masks huge volatility with large market gains in 2006 and the later half of 2009 and 2010, with large drops in the interim.

Excess Return

As can be seen from the charts below:

1. Active managers generally did well, again with Growth being a harder style to add value.
2. Smaller managers tended to outperform in 5 of the 9 market cap and style segments.
3. In 3 of the 9 market cap and style segments, there was very little advantage to size.
4. For this time period, there was a clear advantage to size in the Mid Cap Growth space. It should be noted that active managers were able to add value in that segment, and that the Mid Cap Growth space had the best performance among the 9 segments.

Excess Return Trends for US Equity Managers by Mandate Market Cap, Mandate Style and Size of Manager for the 5 years ending June 30, 2010



Five Years Ending 2009

Market Environment

As can be seen from the chart below, rolling back the returns by another year results in a chart filled with red. At this point in time, the good years of 2005 and 2006 have been completely negated by the full impact of the financial crisis resulting from the decline in home values.

5 Years Ending June 2009

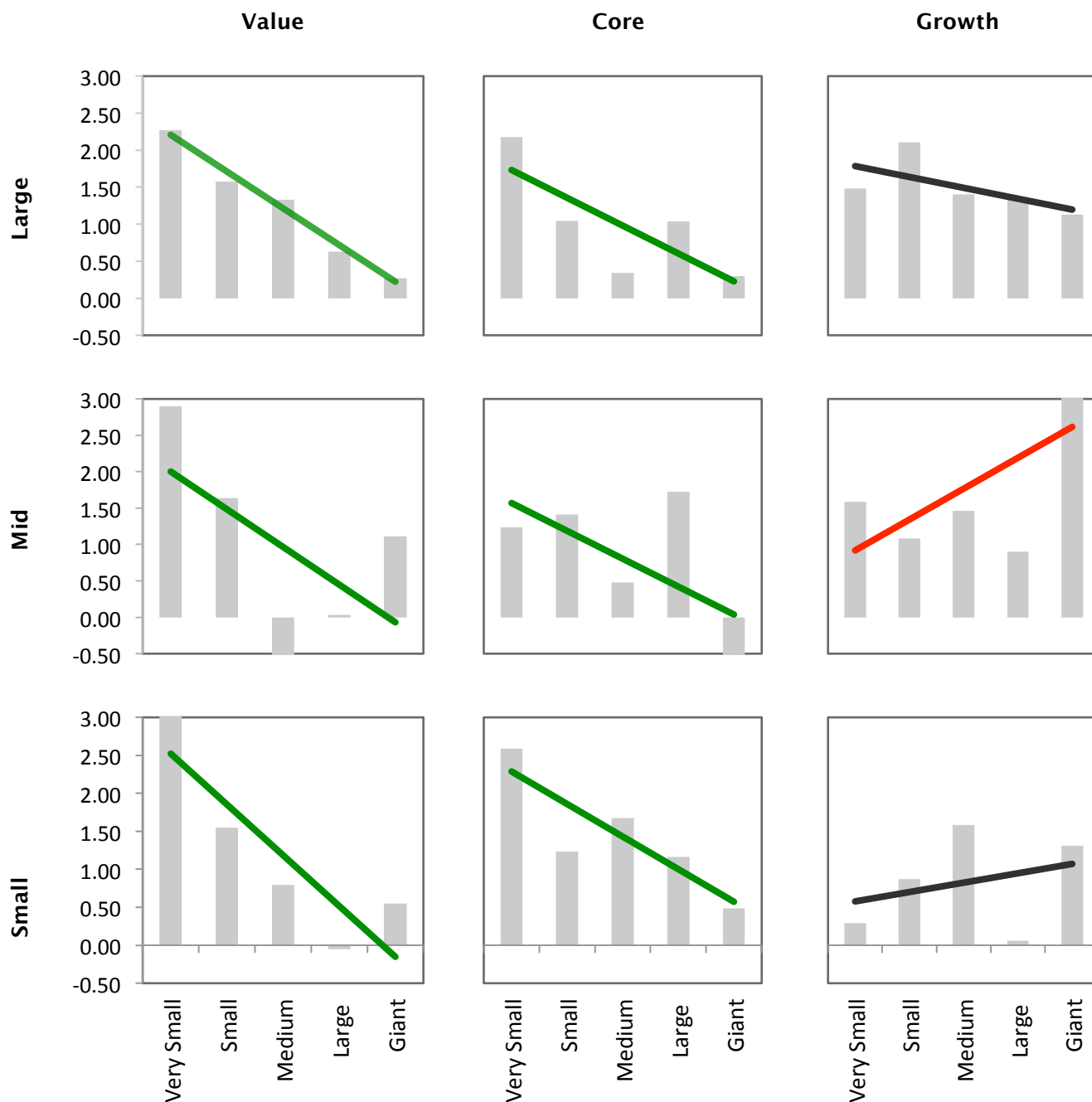
	Value	Core	Growth
Large Cap	-2.13	-1.85	-1.83
Mid Cap	-0.43	-0.11	-0.44
Small Cap	-2.27	-1.71	-1.32

Excess Return

As can be seen from the charts below, in a difficult 5 years for the market we can draw the following conclusions:

1. Active managers generally did well.
2. Smaller managers tended to outperform in 6 of the 9 market cap and style segments.
3. In 2 of the 9 market cap and style segments, there was very little advantage to size.
4. For this time period, there was a clear advantage to size in the Mid Cap Growth space. It should be noted that active managers were able to add value in that segment.

Excess Return Trends for US Equity Managers by Mandate Market Cap, Mandate Style and Size of Manager for the 5 years ending June 30, 2009



Conclusions:

1. Many studies have shown that smaller managers tend to perform better than larger managers. In this paper, based on longer-term 5 year data, we show that:
 - a. There are better than even odds (15 out of 27 or 56%) that there is an excess return advantage to using smaller managers. During the 3 overlapping five-year periods we look at, this advantage is clear in the Value and Core styles across the market cap range. In the Mid Cap Growth segment, while active managers generally outperformed, there seemed to be an advantage to larger managers.
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Please feel free to contact our CEO at monika@alturacap.com, or (212) 378-7133 for more information.

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Mr. Van Orden is responsible for leading Altura’s investment committee, to provide oversight and insight to manager selection, fund construction, and investment department operation.



Lisa Kopp *Director of Research*

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Ravindra Deo *Chief Investment Officer & Chief Technology Officer*

Mr. Deo is responsible for the philosophy, process, and operation of the investment department, and for the technology infrastructure of the firm, including the management of the Emerging Manager Information Platform.



Jay Garcia *Chief Financial Officer & Chief Operating Officer*

Mr. Garcia is responsible for oversight and management of Altura’s financials, operations, and infrastructure. He also provides research insight and strategic guidance based on his experience as a director of securities analysis and partner/portfolio manager.



Monika Mantilla *President and CEO*

Ms. Mantilla is responsible for the overall strategic direction and leadership of the firm, including client relationship, marketing, product development, human capital development and financial management.

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