ACTIVE VS. PASSIVE INVESTING: FOCUS ON SMALL-CAP EQUITIES

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OUTLINE

- Active versus passive investment management: which is more successful for small-cap investing?
- Which small-cap indices does Stratford use?
- What are other methods of benchmarking small-cap managers?

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ACTIVE VS. PASSIVE: METHODOLOGY

- Began with the Morningstar Principia Pro database

- Eliminated funds that did not fall into the following asset classes:

  - large-cap equity
  - mid-cap equity
  - small-cap equity
  - international equity
  - market duration fixed income

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ACTIVE VS. PASSIVE: METHODOLOGY

- Further segregated the domestic equity asset classes into growth and value
- Evaluated risk-adjusted performance over rolling five-year time periods spanning the ten years from 1991 to 2000
- Limitations:
  - survivorship bias (poor-performing funds tend to leave the universe)
  - database includes retail funds typically with higher expenses than institutional funds

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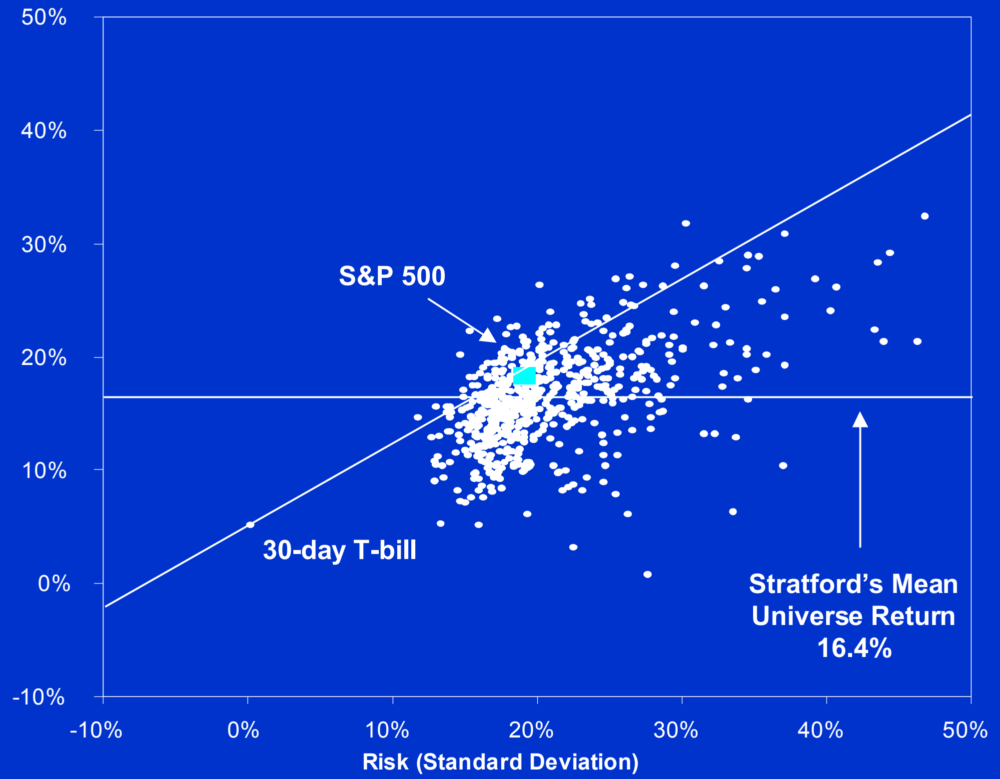
ACTIVE VS. PASSIVE: RESULTS

➤ **The case for passive management: large-cap equities**

Five Years Ended December 31, 2000



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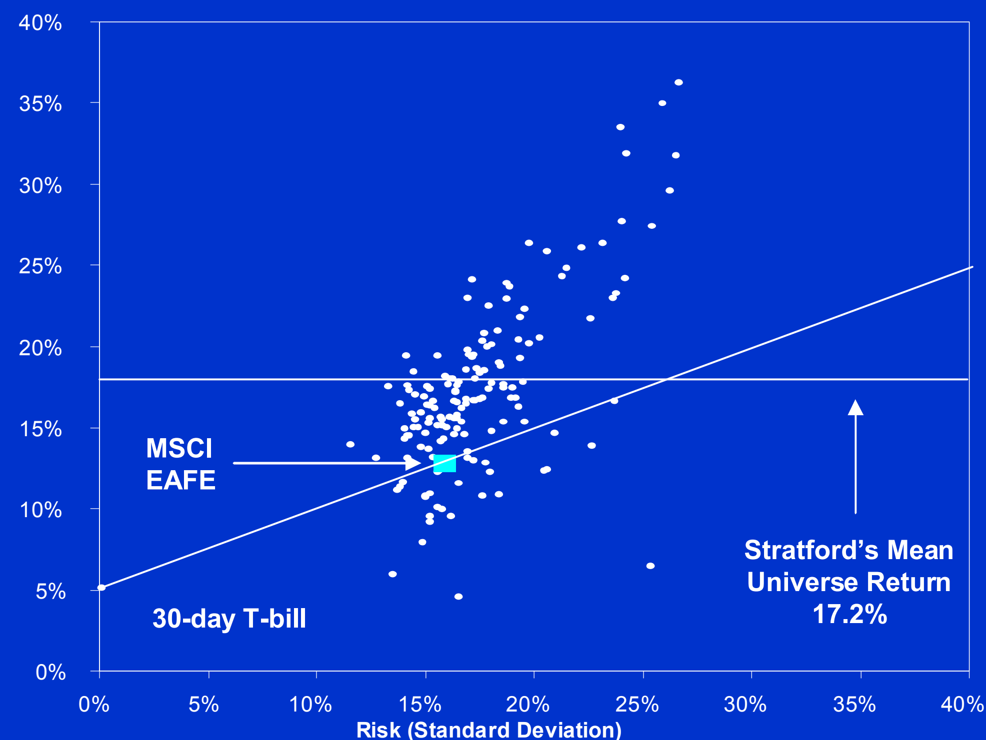
ACTIVE VS. PASSIVE: RESULTS

➢ **Not quite as convincing: international equities**

Five Years Ended December 31, 1999



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ACTIVE VS. PASSIVE: SMALL-CAP EQUITIES

- Small-cap equity results were mixed
  - 1995, 1998, 2000 managers outperformed
  - 1996, 1997, 1999 inconclusive
  - Wide margin of out/underperformance
- Small-cap value results were mixed
  - Underperformers lost more value than outperformers added value

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ACTIVE VS. PASSIVE: SMALL-CAP EQUITIES

- **Small-cap growth results favored active management**
  - **Over periods measured, more managers outperformed on a risk-adjusted basis than lagged**
  - **Outperformers did so by a wide margin**
  - **Active management during these periods would have added more value than passive management**

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ACTIVE VS. PASSIVE: QUALITATIVE FACTORS

- Over 7,000 stocks in the small-cap universe
- Both active and passive managers have high tracking error relative to the indices
- Active management trading costs are high, as are active management fees
- The typical small-cap stock has fewer analysts covering it than its large-cap counterpart
- Analysts have easier access to small company management

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ACTIVE VS. PASSIVE: CONCLUSIONS OF THE STUDY

- Active management will likely result in better returns for small-cap growth and international equities

- Passive strategies will likely be more successful for large-cap, mid-cap, and fixed income markets

- Final decision depends on an investor's willingness to cope with each strategy's tradeoffs
  - Do you like identifying outperformers?
  - Are you a market timer?
  - Do you have the time to commit to monitor active managers?

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STRATFORD'S SMALL-CAP BENCHMARK USE

- You guessed it - the Russell 2000 indices
- Why?
  - Simple data collection
  - Simple to understand and explain
  - Broad universe of securities represented
  - Most widely used by investment managers and the public

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STRATFORD’S SMALL-CAP BENCHMARK USE

- Why *not* use the Russell indices?
  - Peter’s comments on the rebalancing effect
  - Heavy technology weighting can unduly influence returns
  - Rebalancing only once a year can lead to market cap and style creep

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STRATFORD'S SMALL-CAP PERFORMANCE MEASURES

- Given the inherent problems with the small-cap indices, what other methods exist to measure small-cap manager performance?
  - Peer group performance over rolling periods
  - Peer group performance over calendar years

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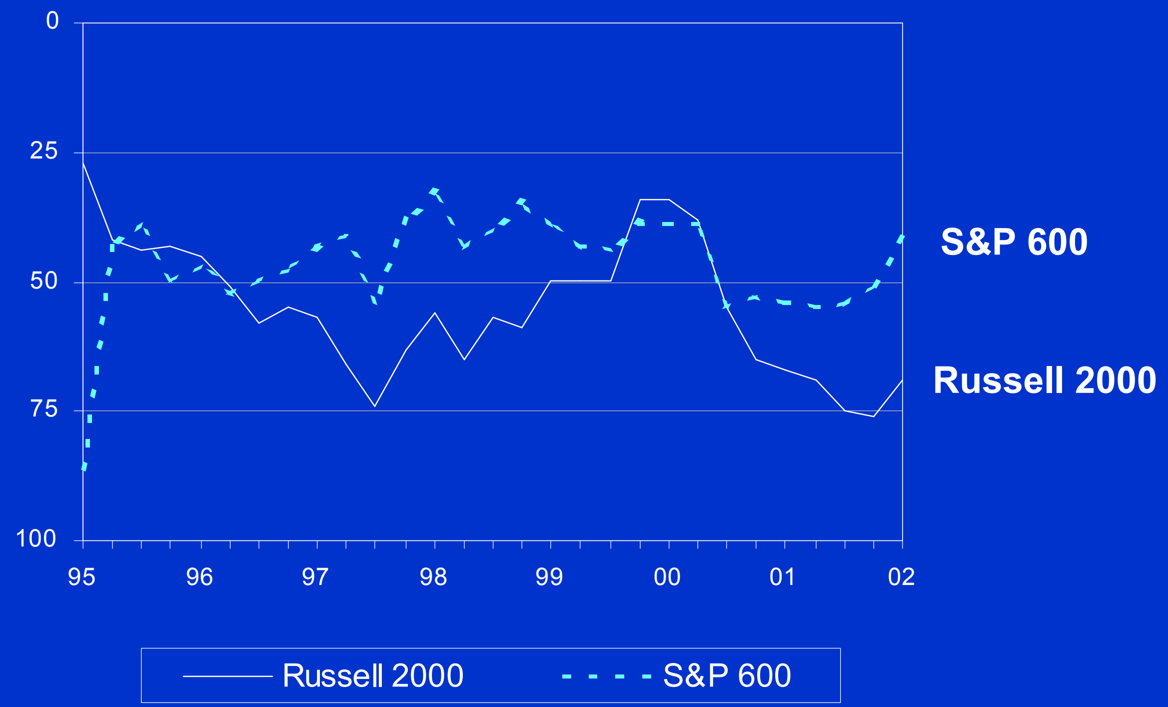
STRATFORD'S SMALL-CAP PERFORMANCE MEASURES

Russell 2000 and S&P 600 Rankings within the Stratford Small-cap Equity Peer Group



STRATFORD'S SMALL-CAP PERFORMANCE MEASURES

Periods Ended Dec. 31	2001		2000		1999		1998	
	Return	Rank	Return	Rank	Return	Rank	Return	Rank
Russell 2000	2.5%	52	-3.0%	68	21.3%	31	-2.6%	41
S&P 600	6.5%	43	11.8%	40	12.4%	43	-1.3%	37
Small-cap Equity Peer Group Median	3.6%	50	7.4%	50	8.5%	50	-4.3%	50

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CONCLUSIONS

- Qualitative and quantitative factors still favor active management over passive for small-cap equities
- Despite flaws, the Russell 2000 indices continue to be the small-cap benchmarks of choice for managers and consultants
- Peer group comparison is vital for a thorough evaluation of small-cap managers

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