Rational Expectations for Active International Investing

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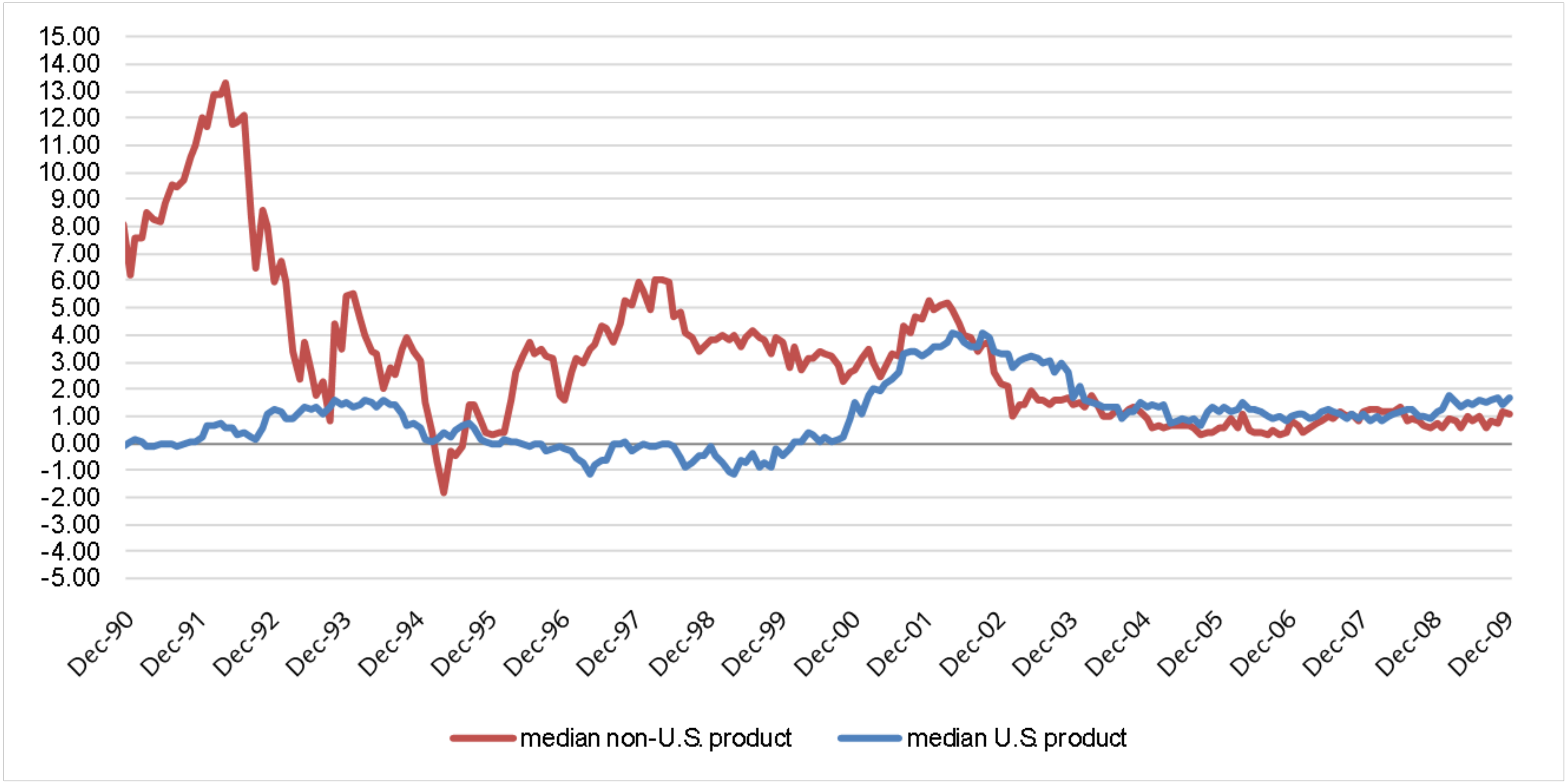
A LEVEL PLAYING FIELD

- Investors have come to expect more active return from managers of non-U.S. products than from managers of U.S. products
  - Country selection has played a large role in creating expectations
    - The “Japan Effect”
- In the past 10 years, the world has become a different place
  - Drivers of excess returns have changed
    - Country selection vs. industry selection vs. bottom-up stock selection
  - Excess returns of active non-U.S. and U.S. strategies have converged
- Investors may wish to rethink return expectations for active non-U.S. equity strategies

CONVERGENCE OF EXCESS RETURNS

Median Rolling 36-Month Annualized Excess Returns for U.S. and Non-U.S. Large Cap Products



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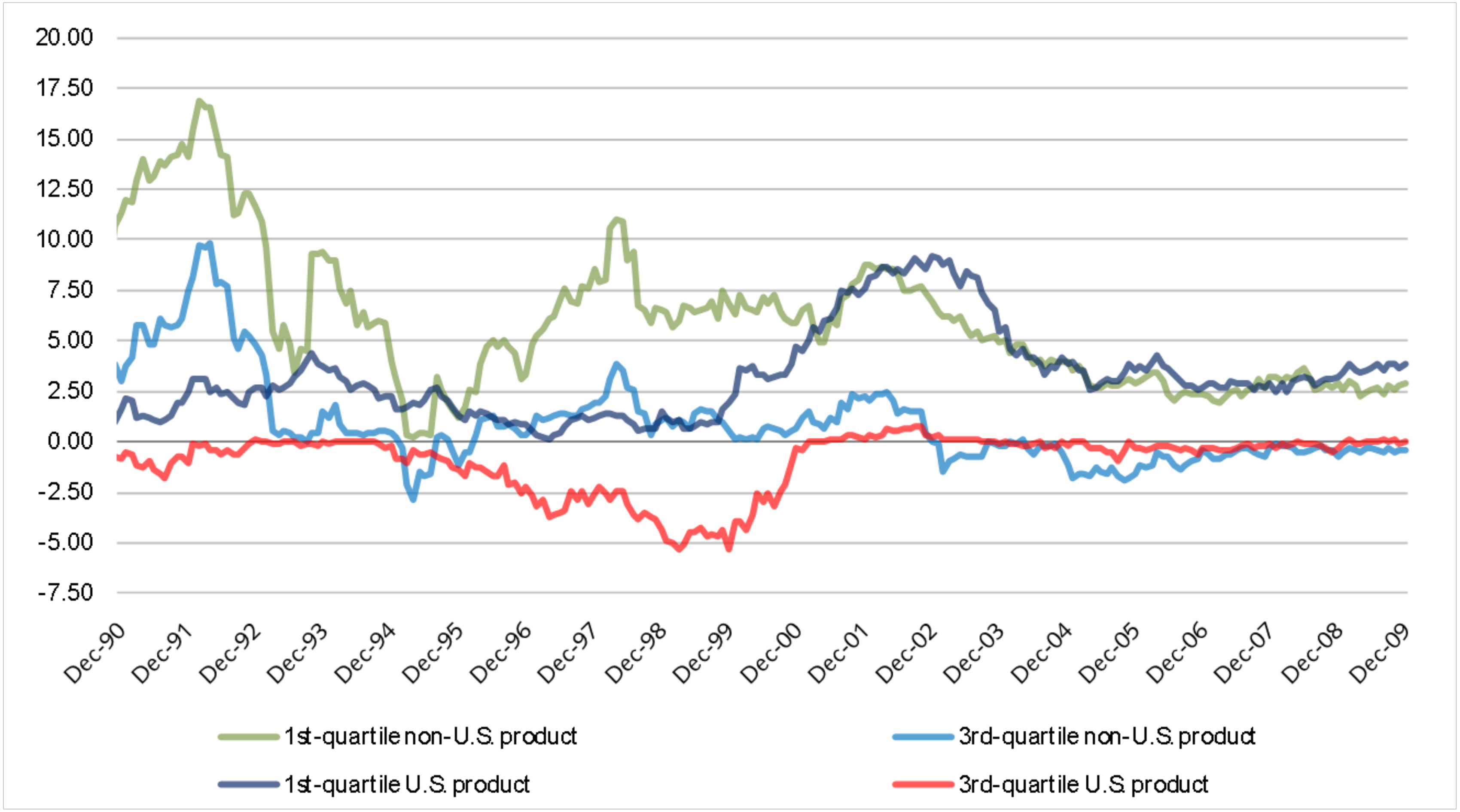
RETHINKING EXPECTATIONS

First- and Third-Quartile Rolling 36-Month Annualized Excess Returns for U.S. and Non-U.S. Large Cap Products



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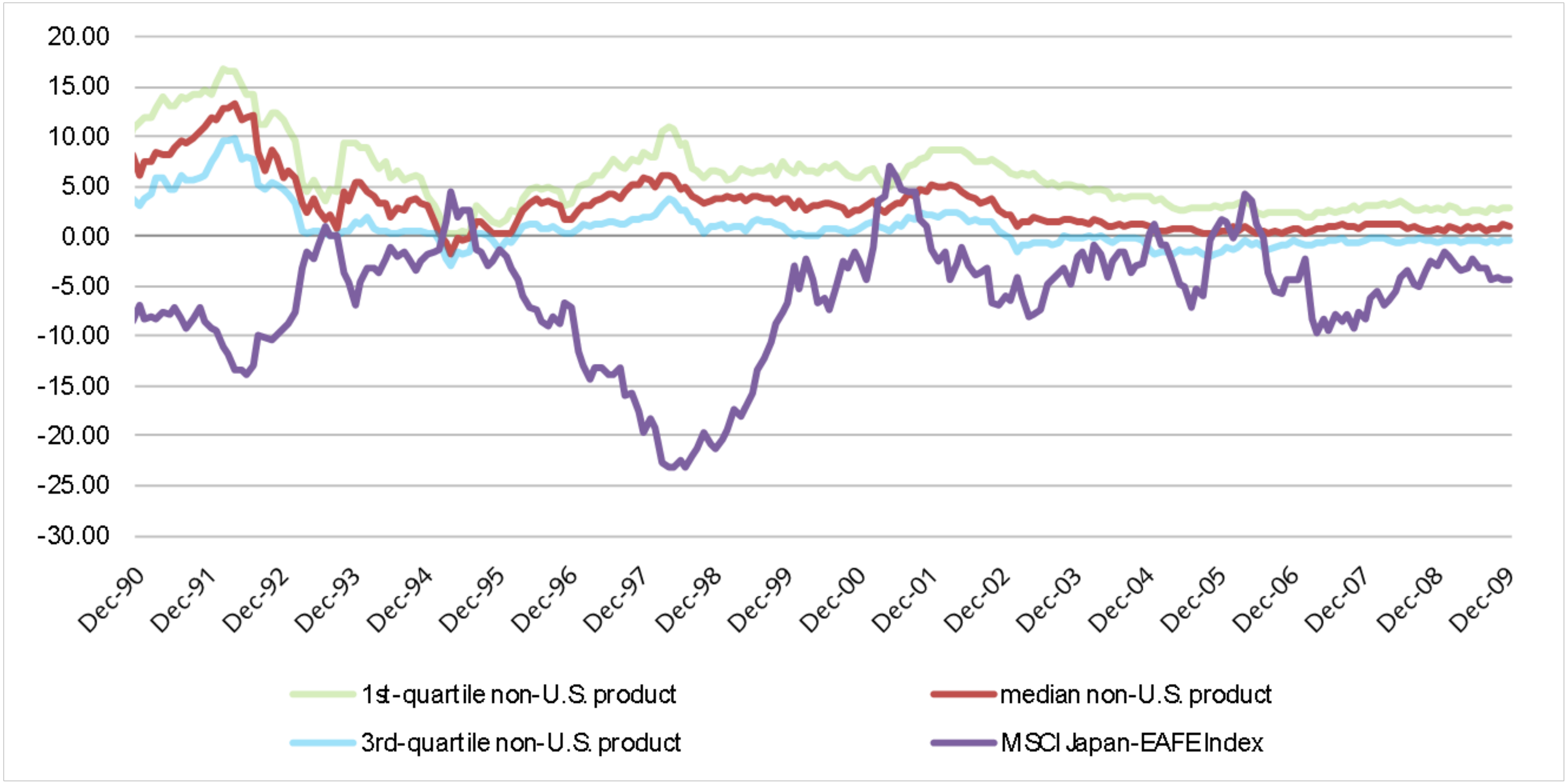
THE JAPAN EFFECT

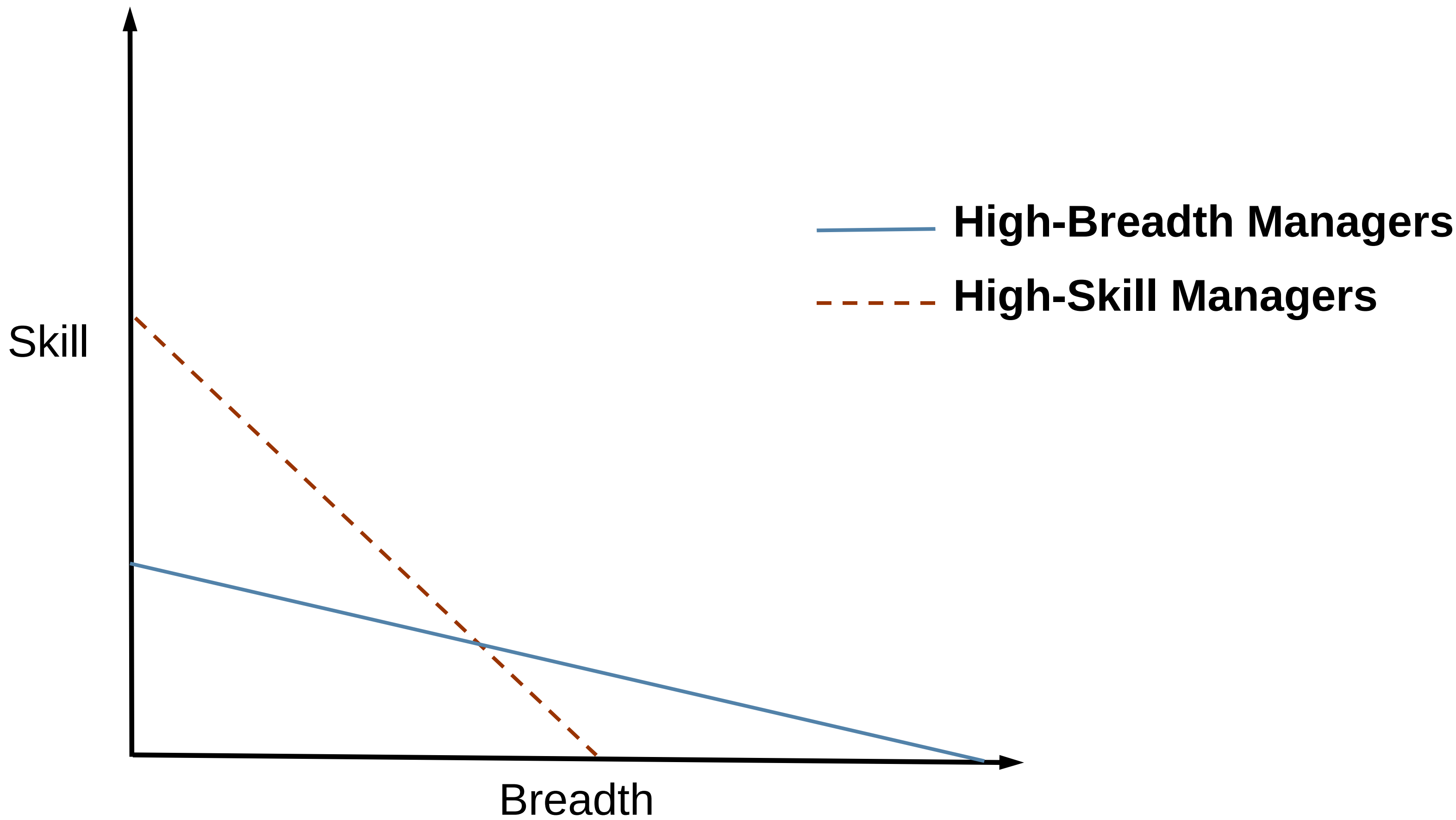
First- and Third-Quartile and Median Rolling 36-Month Annualized Excess Returns for Non-U.S. Large Cap Products and the Performance of the MSCI Japan Index Relative to the MSCI EAFE Index



DOES ACTIVE MANAGEMENT STILL MAKE SENSE?

- Many investors believe that active management adds value
  - Even in generally efficient markets
- Investors using active U.S. equity strategies have increasingly focused on efficiency
  - Higher risk-adjusted active returns
    - Information ratio
- Investors in active non-U.S. strategies can take a page from this book
- A broadly diversified, bottom-up approach to stock selection may be the most efficient way to capture alpha
  - Capitalize on breadth

BREADTH VERSUS SKILL



This figure is for illustrative purposes only.

BEWARE OF BAD BREADTH!

- Not all bottom-up strategies capitalize on breadth
  - Number of positions
    - Holding a large number of positions at their benchmark weight
  - Number of active positions
    - Overweighting undervalued and underweighting overvalued securities
  - Number of independent active positions
    - Maximizing the number of independent active positions at any given point in time
  - Frequency with which investment decisions are exercised
    - Making a large number of independent investment decisions over time
  - Watch out for false “diversification”

NOTES

1. Information ratio is defined as the annualized excess return divided by the annualized tracking error for the performance period in question. The tracking error of a portfolio is the standard deviation of that portfolio's excess returns relative to the benchmark index.

2. Sources for Slides 4, 5, and 6:

   - eVestment Alliance, LLC ("eVestment") database, "Large Cap Equity" universe, screened for all active products benchmarked to the S&P 500 providing gross returns, excluding products using either a mutual fund or retail wrap account as a default vehicle.

   - eVestment database, "International Equity" universe, screened for all unhedged active products benchmarked to the MSCI EAFE ND Index providing gross returns, excluding products using either a mutual fund or retail wrap account as a default vehicle.

3. MSCI Inc. is the source and copyright owner of MSCI Japan Index.