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## Special Report: IROs on Buy-side Communications

After a bruising 2008, the words “Happy New Year” have never sounded so good. Given the dramatic performance in the global equity, debt, credit, and commodity markets in 2008, Ipreo thought it was a good time to garner feedback from our clients as to how the upheaval in 2008 is impacting communication to and from the buy-side.

2008 was unique in that few types of money managers were spared. Headlines blared about the poor performance and loss of assets from the full spectrum of investors, including some of the world’s most prominent hedge funds (e.g. Citadel, Ospraie) as well as traditional, long-only, value investors (e.g. Brandes, Dodge & Cox).

We wanted to hear from our clients as to if and how this historically poor performance is impacting the overall psyche of the buy-side and how it is affecting communications with the group. We spoke to more than 20 clients from various sectors. Below is a summary of the common themes that came from these discussions and how Ipreo’s clients have altered their communication strategy with investment managers.

- 1. The buy-side’s appetite for meetings with companies has not abated.** In fact, with just a few exceptions our clients feel that meetings and meeting requests from the buy-side have gone up, particularly since the end of October when the markets calmed (in relative terms, of course). For clients that met with investors on non-deal roadshows, filling up a schedule of one-on-one meetings or group meetings was a relatively easy process, regardless of their sector. A few of our financial sector clients indicated that the number of analysts and portfolio managers that attended one-on-one meetings was abnormally high. It stands to reason that given the outsized impact financials have had on the overall market, more buy-side staff would be interested to sit in on these meetings.
- 2. Incoming phone calls are down.** Although investor meetings have not been impacted, many clients are reporting lower incoming call volumes from the buy-side. We believe there are three primary reasons for the lower incoming call volume: First, the buy-side is currently in a defensive mode and initial outreach to companies that are prospective investment opportunities has subsided; second, the buy-side’s interest level in getting a read on Q4 performance has declined significantly relative to its need to support and communicate with its own client base; and third, hedge funds, the source of many inbound calls, have been negatively impacted, more so than any other group on the buy-side, and this has resulted in a hedge fund retrenchment.
- 3. Cash is king.** In speaking with our clients there was nothing that came through more loud and clear than the buy-side’s near singular focus on the balance sheet. Nearly all of our responding clients report that the quality and risks of the balance sheet have dominated conversation with the buy-side like never before. The most common queries focused on cash flow generation, debt servicing and debt covenants, credit facilities, pension fund obligations, and safety of the dividend.
- 4. So, what’s your doomsday scenario?** This question sums up the buy-side’s skittishness and defensive posture. In one form or another, many of our clients are being asked to discuss their worst case scenario regarding earnings in the short-term and its impact. It’s as if the buy-side isn’t even contemplating companies hitting estimates, but they are trying to determine how badly they could miss them.
- 5. Hedge funds remain in the mix.** Despite proclamations of their demise in the financial press, a majority of our clients indicate that their communications with hedge funds has not changed dramatically. As noted earlier, our clients indicate that the number of inbound calls from hedge funds definitely declined, but the number of meetings taking place with hedge funds did not change significantly in 2008. We believe this is the result of many of the smaller funds, which took up a disproportionate amount of an IRO’s time and provided a disproportionate amount of annoyance, pulling back.

### Communication Strategies for 2009

Our clients that participated in the survey indicated that they have indeed re-worked their communication with the buy-side to increase the focus on balance sheet items and liquidity. We expect that these issues will remain very relevant into 2009, and messaging and materials should reflect their importance. If possible, the safety and stability of your balance sheet in current economic and industry conditions and potentially worsening conditions should be emphasized to address the inevitable “doomsday” or “worst-case” scenario question. While we don’t recommend succumbing to the buy-side’s decidedly negative vernacular, a clear-minded assessment of balance sheet risks is necessary. It is also important

to proactively communicate with the buy-side (both shareholders and targets) during this period of decreased incoming communications. Your communications should acknowledge the current environment and detail the initiatives that have been put in place to manage your way through it. We do expect the buy-side to emerge from their shell-shocked state of mind and heighten their level of analysis to identify the companies that are managing their way through this environment more effectively than others.

Additionally, since the failure of Lehman Brothers, “counterparty risk,” either in the security analysis sense of the term or the operational sense of the term, has been brought back to the forefront. The potential of one of your suppliers or customers being the next Steve & Barry’s or IndyMac Bank is something that’s on the mind of every analyst who has to perform due diligence on your company. While staying within your disclosures, clearly describing your process for assessing counterparty or customer risk internally can reassure your investors.

There is hope for 2009. Everyone, particularly the buy-side, is itching for a return to fundamentals. According to a fourth quarter survey by Russell Investments, 72% of the money managers they surveyed feel the U.S. equity markets are undervalued, which is the highest level in the survey’s history. Additionally, 50% of the managers believe that equity markets will rise by more than 10% in 2009. Of course, most buy-side managers would be inclined to believe or at least hope for an advancing market following the damage done in 2008. Compelling fundamentals are in place, but the fear and panic that characterized much of 2008 remains. Your communications should take on the buy-side’s concerns head-on in order to remove the fear that is stalling investment decisions.

## Hedge Fund Redemptions: What Hath the Margin Call Wrought?

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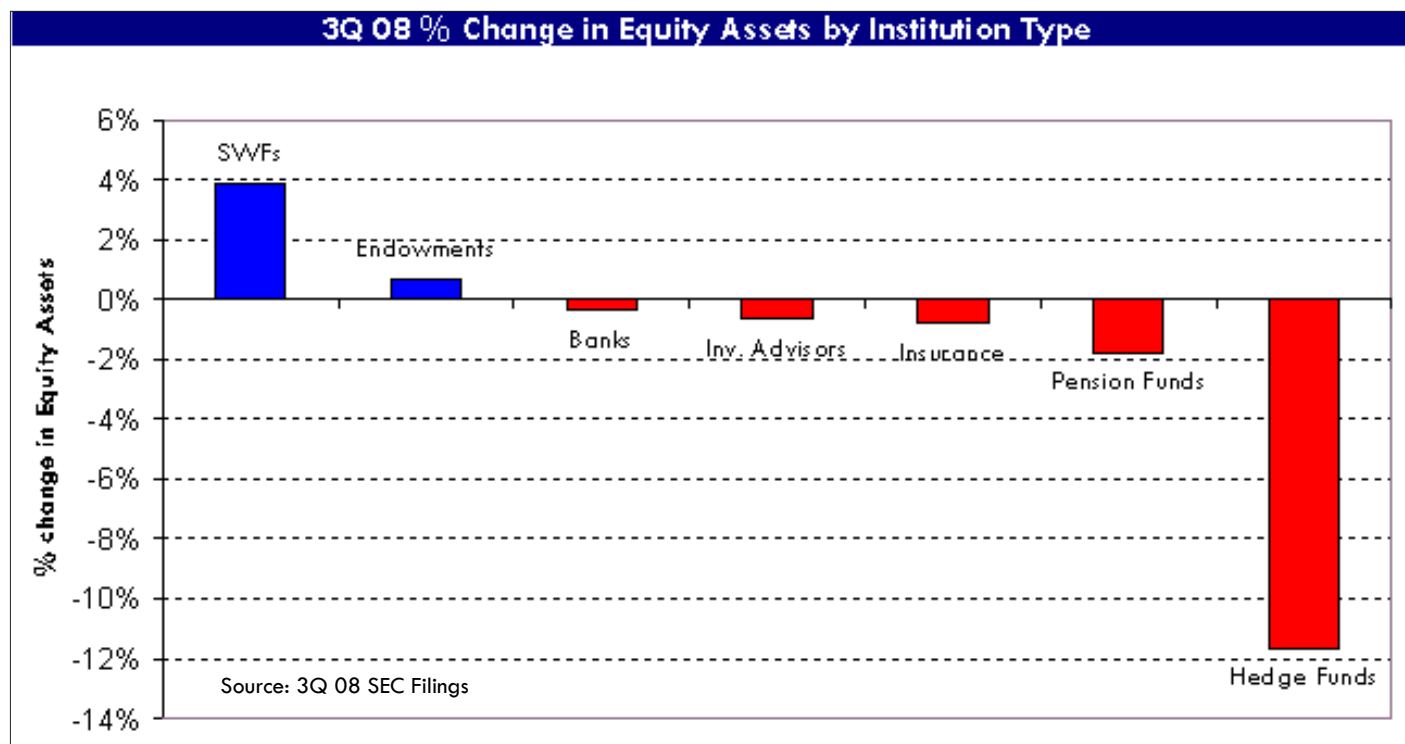
Financial news organizations first began reporting rumors of forced sales by investment managers, particularly hedge fund managers, in early September 2008 as the financial crisis intensified.

“Margin calls” to hedge funds came from two fronts. First, hedge fund clients, though often under longer-term lockup periods, began asking questions about their funds’ holdings – as qualified investors, these customers tend to keep a much closer watch on their day-to-day positions than the traditional retail or pension client base. Second, prime brokerages that offered their hedge fund clients leverage, while having access to their clients’ account positions, began to pull back on their leverage terms, while outside banks offering leverage to hedge funds saw the crisis facing them after the failure of Lehman Brothers as an immediate need to de-risk.

Therefore, a more significant portion of trading in US equities since September 2008 was likely sourced back to hedge fund managers attempting to respond to their customers and providers, with the obvious effect of weakening a market with sellers less price-sensitive than buyers. While most hedge funds have not yet publicly disclosed their positions as of the end of 2008 (with most expected to report form 13F in the middle of February 2009), we can use several methods to measure the effects of forced liquidations in third quarter 2008, fourth quarter 2008, and first quarter 2009.

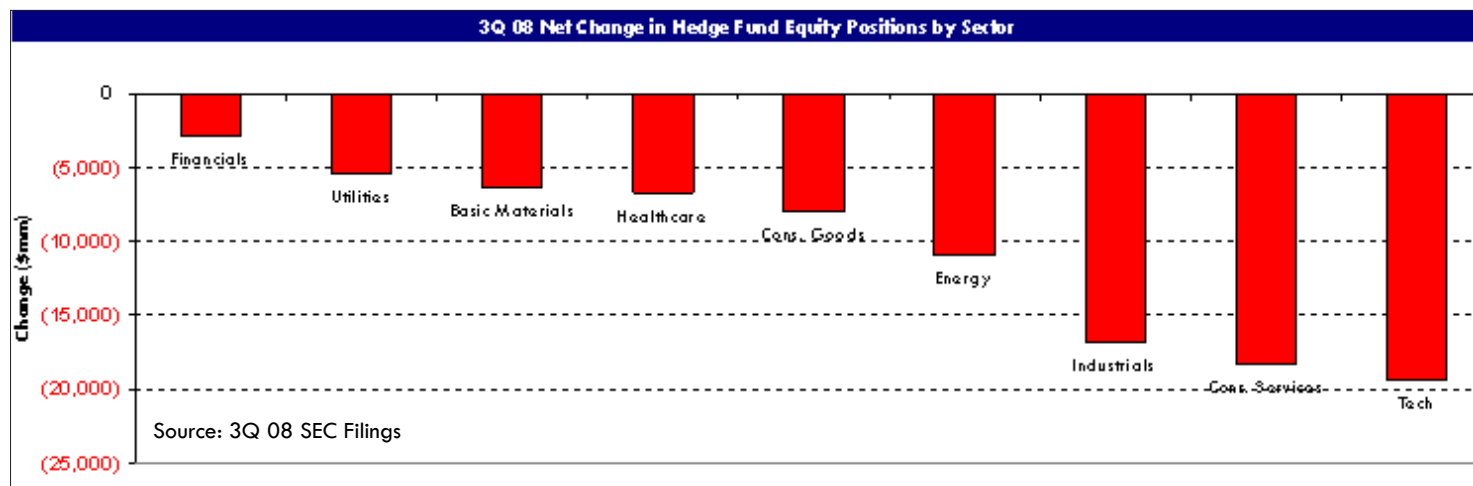
#### **Third Quarter 2008:**

As investors demanded further redemptions and many managers decided to sit out the volatility in the equity markets, hedge funds saw a net decrease of nearly \$100 billion of equity positions during the three months ended September 30. Despite representing a much smaller portion of the overall institutional investment management universe, this figure nearly matched in size the total decrease from all registered investment advisors.



From the hedge fund managers that reported to the SEC, the technology sector was hardest hit, losing nearly \$30 billion in hedge fund holdings. The financial sector fared best amongst hedge funds, perhaps because so many funds had shorted or exited the sector prior to the short-selling ban temporarily imposed by the SEC; hedge funds simply did not have many equity holdings in the financial sector to liquidate. The financial sector was also most active in the new issuance market, with many blue-chip financial institutions issuing multi-billion dollar follow-ons during the third quarter to shore up balance sheets and offset loan losses. The major new issuance activity, lack of convertible debt offerings and short-selling ban each contributed to a lack of selling pressure within financials.

Of the hedge funds that reported equity holdings, 321 were net equity buyers during the period while 516 reduced their equity positions, due to lack of market confidence or increases in redemptions and deleveraging. Well-known manager Paulson & Co saw the largest increase in equity holdings, increasing its position by more than \$3.7 billion. Vinik Asset Management saw the largest decline in its equity position during the period, decreasing by \$7.5 billion.



**Fourth Quarter 2008:**

Though no public data set is fully available to assess the magnitude of sales from hedge fund managers seen in the quarter, we can see some of the effects of these sales by examining the performance of the issues that were the most widely held by hedge fund managers at the beginning of the period; these issues should prove to be the ones most vulnerable to downward pressure based on hedge fund liquidations and redemptions.

Selecting a set of the 10 US issues (exceeding \$1b market cap) with the highest percentage of outstanding shares held by hedge funds at the beginning of the fourth quarter (excluding issues that represented merger arbitrage opportunities), Ipreo found that in each sector, except for financials, the “hedge fund favorites” group on average underperformed its sector benchmark over the YTD period and QTD through the Christmas holiday. For example, in the table below, the 10 basic materials issues with the largest hedge fund ownership underperformed the S&P basic materials index (median return lagging by 17.4% and mean return lagging by 10.1%).

Top 10 "Hedge Fund Favorites" by Sector (Listed Alphabetically by Sector)- Excess Return vs. Benchmark						
Sector	Mean Excess Return			Median Excess Return		
	QTD Perf vs. S&P 500	YTD Perf vs. S&P 500	QTD Perf Vs. Sector Index	QTD Perf vs. S&P 500	YTD Perf vs. S&P 500	QTD Perf Vs. Sector Index
Basic Materials Top 10	-14.6%	-13.5%	-10.1%	-23.1%	-27.6%	-17.4%
Consumer Goods Top 10	-10.6%	-11.5%	-15.0%	-2.9%	-8.1%	-1.7%
Consumer Services Top 10	1.6%	-1.1%	-7.7%	-12.5%	0.0%	-9.0%
Energy Top 10	-16.4%	-15.7%	-20.2%	4.0%	9.1%	-2.8%
Financials Top 10	-8.2%	-16.8%	7.6%	-7.8%	-18.0%	8.1%
Healthcare Top 10	4.9%	27.0%	-1.9%	-16.6%	-14.5%	-20.3%
Industrials Top 10	-13.1%	-1.2%	-9.6%	-11.7%	-13.3%	-16.1%
Technology Top 10	-4.3%	-7.5%	-3.1%	-7.3%	-6.4%	-16.5%
Utilities Top 10	4.2%	-1.7%	-6.6%	3.8%	-2.0%	-7.0%

Financials, as with the third quarter above, may have much of their liquidations behind them, as issuers with large concentrations of hedge funds in their shareholder base outperformed the rest of the sector (and larger issuers with more traditional shareholder bases).

Top 10 US Securities in Financials Sector by % O/S Held by Hedge Fund Managers							
Security	Ticker	# of Hedge Funds with stock in top 10 Holdings	% of O/S held by HF's	Market Cap \$M	QTD Perf vs. S&P 500	YTD Perf vs. S&P 500	QTD Perf Vs. Sector Index
First American Corporation	FAF	2	22.5%	2,615.2	19.0%	21.9%	34.9%
MFA Mortgage	MFA	5	22.3%	1,250.7	11.4%	1.2%	27.2%
CapitalSource, Inc.	CSE	5	20.8%	1,482.5	-39.2%	-34.5%	-23.3%
MasterCard Incorporated CL A	MA	20	19.8%	14,627.9	2.7%	4.6%	18.6%
MSCI, Inc. CL A	MXB	3	19.2%	1,193.7	-7.2%	-17.2%	8.7%
First Horizon National Corporation	FHN	5	16.7%	2,095.6	28.6%	-4.6%	44.4%
SLM Corporation	SLM	11	16.1%	4,336.4	-8.4%	-18.8%	7.5%
CB Richard Ellis Group, Inc. CL A	CBG	3	14.2%	1,121.3	-45.0%	-41.0%	-29.2%
CIT Group, Inc.	CIT	3	13.7%	1,292.0	-13.3%	-41.9%	2.5%
Health Net, Inc.	HNT	2	12.6%	1,116.7	-31.1%	-38.2%	-15.2%
<b>Group Median</b>					<b>-7.8%</b>	<b>-18.0%</b>	<b>8.1%</b>
<b>Group Mean</b>					<b>-8.2%</b>	<b>-16.8%</b>	<b>7.6%</b>

“Hedge fund favorites” in the energy space were particularly hard hit, with the top 10 lagging the S&P 500 Energy Index by over 20%.

Top 10 US Securities in Energy Sector by % O/S Held by Hedge Fund Managers							
Security	Ticker	# of Hedge Funds with stock in top 10 Holdings	% of O/S held by HF's	Market Cap \$M	QTD Perf vs. S&P 500	YTD Perf vs. S&P 500	QTD Perf Vs. Sector Index
Walter Industries	WLT	11	23.3%	1,109.0	-34.7%	-6.0%	-38.4%
Linn Energy, LLC	LINE	5	21.3%	1,474.0	9.2%	-8.1%	5.4%
SandRidge Energy, Inc.	SD	6	21.1%	1,062.8	-45.1%	-43.3%	-48.8%
EXCO Resources, Inc.	XCO	8	18.8%	1,908.9	-25.3%	-6.9%	-29.0%
Plains Exploration & Production Company	PXP	9	18.4%	2,457.6	-13.8%	-19.7%	-17.5%
Exterran Holdings, Inc.	EXH	7	16.7%	1,428.1	-12.9%	-35.5%	-16.7%
Frontier Oil Corporation	FTO	1	14.6%	1,370.5	-10.4%	-30.4%	-14.2%
Rowan Companies, Inc.	RDC	1	13.5%	1,903.0	-21.7%	-18.2%	-25.4%
Kinder Morgan Management, LLC	KMR	2	12.0%	3,086.1	9.8%	22.2%	6.1%
Pride International, Inc.	PDE	5	11.4%	2,926.6	-19.4%	-10.9%	-23.2%
<b>Group Median</b>					<b>-16.6%</b>	<b>-14.5%</b>	<b>-20.3%</b>
<b>Group Mean</b>					<b>-16.4%</b>	<b>-15.7%</b>	<b>-20.2%</b>

### First Quarter 2009:

While it's likely that much of the forced sales required by leverage providers were made over a shorter period of time in the midst of the crisis and may be largely complete, it is important to note that many hedge funds, may continue to receive redemption requests from investors and be forced to sell positions. Depending on the fund, often the required grace period before a redemption from a hedge fund can be 60 or 90 days, meaning that a request from an investor that first looked to exit a hedge fund in October may only now in January be fulfilled. Also, numerous hedge funds have chosen to "put up the wall" and refuse to accept redemption requests from clients, including Fortress, Citadel, and ToscaFund, while others have negotiated with managers to adjust their fee schedules in return for relief from redemptions.

Anecdotally, US equity markets seem to be performing more smoothly in the first several days of 2009; volatility (as measured by the VIX) is down sharply, and market depth and continuity anecdotally appear stronger. A market dominated by "forced sellers" on one side is generally not a well-functioning one, but it is possible that US stocks have come through the worst of it and may now begin to see both buyers and sellers acting with the same price sensitivity as they always have.

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## BetterIR - Firm Snapshot

**Targeted Firm:** DePrince Race & Zollo, Inc. (3,245.71mm)

### Targeting Profile:

DePrince Race & Zollo is an Orlando-based value and income investor. The firm manages a suite of cap-specific value funds, equity income funds, and an international fund. For its value plays, DePrince works bottom-up to identify securities trading near the low end of ten-year historical valuations. Price to earnings and price to cash flow are important metrics, and yields of 1.5x above the market are ideal. For its income funds, DePrince looks for strong balance sheets with the ability to protect and maintain high payouts. DePrince's main drawback as a target is its high turnover (128%), which has risen significantly over the past two years. As an income investor, DePrince is likely to turn over holdings which reduce or suspend dividends—a phenomenon that has been on the rise since the downturn in the market.

The DePrince website features a John Maynard Keynes quote stating, "Successful investing is anticipating the anticipations of others." This quote hints at some contrarian thinking at DePrince, and the firm's third quarter activity lends further support. While many investors fled the Financial sector in Q3, DePrince loaded up, recording top-ten buys in Zions Bancorporation, SunTrust Bank, Fifth Third Bancorp, Bank of New York Mellon, Bank of America, and KeyCorp. All told, buying in the Financial Services industry totaled \$366mm, or roughly 35% of third quarter buying. Meanwhile, as experts preached the relative safety of consumer discretionary stocks, DePrince acted otherwise. Top third quarter sells were recorded in The Clorox Company (-\$67.0mm), Campbell Soup Co. (-\$52.8mm), and Kimberly-Clark (-\$52.8mm). Regarded as another relative safe-haven, healthcare plays were also sold in the third quarter—led by liquidations in Eli Lilly (-\$25.3mm) and Sanofi-Aventis (-\$22.6mm), and selling in Bristol Myers Squibb (-\$18.4mm).

### How to Approach:

Having a high dividend is definitely of appeal at DePrince. Dividend yield amongst the firm's top twenty-five equity holdings averaged a respectable 4.5% (average yield of the S&P 500 is currently 2.8%). Perhaps more importantly, however, DePrince likely seeks reassurance that your firm's dividend—whatever it may be—can be protected and maintained. In the third

quarter, DePrince sold convincingly across its higher-yielding positions on due suspicion that payout levels could not be maintained. If your firm pays a low or non-existent dividend, do not consider yourself out-of-luck. Nine percent of DePrince's portfolio pays no dividend, and roughly 25% pays out below the S&P 500. Without a dividend, attention will turn to your firm's value story. Many of DePrince's low-yield holdings are concentrated in the Financial Services and Banking sectors, where once-high dividends have been slashed and pure-value stories now dominate. Another poster-child value play for the third quarter was recorded in the long-ailing GPS-maker, Garmin for \$37.5mm.

### How Not to Approach:

Growth stocks and high-valued issues may have better luck elsewhere. Again, higher-valued Pharmaceuticals were pared by \$74mm in the third quarter, and traditionally expensive tech stocks are rare in the DePrince portfolio. DePrince's holdings across Technology, Telecommunications, and Semiconductors accounted for a mere 2% of total holdings in the third quarter. If your firm trades in the tech space, DePrince might be a difficult pitch without a convincing value or dividend story. Given DePrince's contrarian behavior in the third quarter, portraying your firm as a "safe play" could generate limited appeal. To be sure, DePrince appreciates strong balance sheets, but without a noteworthy price decline or value opportunity, "safe haven" companies might target elsewhere.

### Investment Potential:

- Mega: \$18.7mm
- Large: \$22.9mm
- Mid: \$26.0mm
- Small: \$9.9mm
- Micro: \$2.1mm

**Average Equity Holding Period:** 0.78 years

## BetterIR - Fund Snapshot

**Targeted Fund:** American Century Ultra Fund (\$5,352.29mm)

### Portfolio Managers:

Keith Lee (816-531-5575, keith\_lee@americancentury.com), Michael Li (816-340-7877, michael\_li@americancentury.com), Stephen Lurito (816-531-5575, steve\_lurito@americancentury.com)

### Targeting Profile:

American Century Investments, based out of Kansas City, is a growth and value investor with approximately \$52.8B in equity assets. The Ultra Fund is the firm's largest mutual fund, accounting for roughly ten percent of the firm's total equities under management. The fund seeks aggressive growth, and targets stocks using a bottom-up approach. Revenue and earnings trends are key considerations, as are peer comparables and growth catalysts. Positions are generally sold as growth metrics slow or deteriorate markedly. As bottom-up, company-specific investors, the Ultra Fund does not aim to time the market. Though it may be difficult in the present environment, Ultra Fund managers traditionally look past macro and broad market trends, preferring instead to let company numbers speak for themselves. The Ultra Fund is concentrated in larger issues, with 49% in large cap, 37% in mega cap, and 12% in mid caps. Small and micro cap positions together account for less than 2% of the portfolio and are of less appeal to fund managers.

In the third quarter, the tech-heavy Ultra Fund recorded most of its buying in Software, Technology Services, and Semiconductors. Top-ten buys were made in Microsoft (\$90.4mm), IBM (\$52.5mm), Hewlett-Packard (\$49.7), and Intel (\$39.6mm). Interestingly, the Ultra Fund also showed considerable interest in the Processed & Packaged Foods sector during the third quarter. Buying in the sector totaled \$101.2mm with plays in Nestle S.A (\$38.0mm), Kellogg Company (\$37.6mm), and General Mills (\$25.7mm). Though not traditionally viewed as growth stocks, the higher valuations maintained amongst these firms, and an increasingly staples-minded consumer were likely of appeal. The Ultra Fund lost its taste for Oil & Gas, and Commodities in third quarter—shedding \$50.3mm from oil stocks, and \$72.1mm from Agricultural Chemicals. The Ultra Fund also reduced exposure to discount retailers in Costco (-\$46.8mm) and Wal-Mart (-\$51.9mm).

### How to Approach:

With cheap stocks plentiful these days, it seems fewer investors are interested in paying handsomely for growth. If your valuations have survived the credit crisis, however, the Ultra Fund may be a strong target. The Ultra Fund bought higher valuations in the Pharmaceutical space in Q3, and picked up particularly high-priced issues in Amazon (\$22.4mm), Activision-Blizzard (\$41.8mm), and McAfee (\$49.4mm) which continue to show strong growth relative to a weak economy. If your company is trading at a discount, but still shows solid revenue growth and trajectory, the Ultra Fund may still be an excellent target. Growth stories trading at value prices are plentiful in today's market, and the Ultra Fund picked up many in the third quarter, with plays like General Dynamics (\$21.5mm) and Accenture (\$29.4mm).

### How Not to Approach:

With a clear majority of its holdings in larger cap issues, smaller firms should likely avoid the Ultra Fund. If your company has growth prospects that are more tied to macro prospects than demonstrable cash flows and revenue growth, the Ultra Fund may be a difficult pitch. Oil & Gas stocks were turned over quickly in the third quarter as profitability eroded following the burst of the commodity bubble. Despite widespread beliefs in the eventual resurgence in commodities, the Ultra Fund shows a clear preference for growth that can be proven in the here and now. If your company has limited history as a publicly-held firm, you may also be at a disadvantage. As bottom-up investors, Ultra Fund managers prefer in-depth histories for modeling and projection efforts.

### Investment Potential:

- Mega: \$68.8mm
- Large: \$45.3mm
- Mid: \$24.4mm
- Small: \$2.85mm
- Micro: NA

**Average Equity Holding Period:** 0.98 years