



LSGI Advisors, Inc. – December 2010

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Stock Picking Returns to Favor: Active Portfolio Management

In a development that is very positive for active portfolio managers—in fact one of the most bullish developments in the last couple of years in our opinion—the strong correlations between individual stocks and the bond market or major market indexes since the 2008 financial crisis are 'decoupling'.

This is an especially bullish signal for active portfolio managers selecting stocks in the most inefficient sectors of the equities market. A recent Bloomberg article noted:

For the first time since the financial crisis started, U.S. shares are moving independently of the bond market, a sign that profits and valuations are guiding investors more than concern about the economy. The 30-day correlation coefficient measuring how often the S&P 500 index moves in tandem with 10-year Treasury yields fell to -0.42 from a record 0.89 in June, data compiled by Bloomberg show.

Readings of 1 indicate prices are moving together, while zero shows no link and -1 means they are going in opposite directions. Stocks and debt are ending a lockstep relationship that began in July 2007 and lasted through the worst recession since the 1930s.

Money managers say the broken connection is bullish as the greatest number of S&P 500 companies in a decade post earnings growth. During the bull market from 2002 to 2007 when the S&P 500's price and profits doubled, the correlation averaged 0.15, data compiled by Bloomberg show. (Source: Bloomberg News)

The Financial Times also had an article last month on a Barclays Capital note on the decline in correlations, the increasing value of stock selection for active portfolio managers, and long term trends:

Barclays says single stock correlations across the US stock market (the Russell 1000 universe) reached a high of 65.5 per cent in May and stayed near to that level in June. But during October, single stock correlations dropped to 21.9 per cent, below their 10-year average. Although nearly all sectors experienced a drop in correlations for their constituent stocks, there were particularly notable falls for the energy, financial, technology and utilities sectors, which Barclays says will allow a return to active stock picking.

Barclays also looked at correlations at the sector level. It found that at the end of May, the correlation of the 10 main US equity sectors was at its highest level since 1950 (in the 99th percentile) and by October it had effectively dropped by half (into the 51st percentile). "Macro has become meaningfully less important today," says Mr Rothman. "We expect to see thematic investing fade in importance and single name stock picking return to prominence."

Another article in the Globe and Mail discussed the high level of stock price correlations and the performance of active portfolio managers:

Savita Subramanian, quantitative strategist at Merrill Lynch, pointed out on Tuesday that just one in five active U.S. fund managers have been outperforming their benchmark index in 2010, an abysmal track record that says something either about the joys of index investing or the futility of stock picking this year. Ms. Subramanian argues the latter. Part of the problem for stock pickers this year is that there has been a relatively high level of correlation among stocks. That's because the stock market has been driven by big-picture events – think of Ireland's financial crisis, or potential rate hikes by China, or inventive monetary policy from the Federal Reserve. . .

Ms. Subramanian expects correlations to fall from the extremely high levels, and expects stock selection to once again outperform the market: "The few times we have seen high correlations . . . the next several years have seen stock selection strategies outperform by a wide margin".

Last, the Wall Street Journal had an article on how active management and stock selection might be back in favor next year:

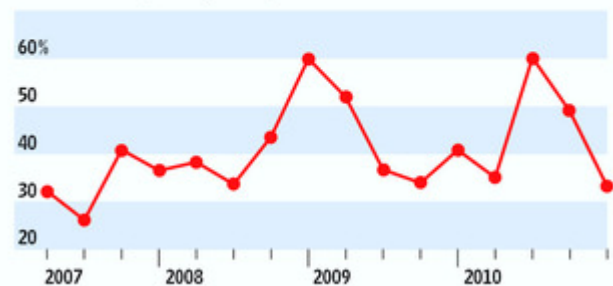
Even the active managers who don't hew closely to an index have had a rough time lately. That's partly because stocks have moved more or less in sync, making it difficult for managers to stand apart. In the one-year and three-year periods ending June 30, 56% of U.S. stock funds lagged the broad market, according to Standard & Poor's.

But things may be looking up for active managers. More than half of both large-cap value and large-cap growth managers beat their benchmarks in November, according to Bank of America Merrill Lynch. One key is shifting "correlations," which measure whether stocks are moving in sync or if many zig while others zag. After hitting historically high levels in May and June, stock correlations fell sharply in October, according to Matthew Rothman, head of quantitative-equity strategies at Barclays Capital.

The decline, which appeared to coincide with the kickoff of third-quarter earnings season, suggests fundamental drivers of stock returns are gaining attention—a good sign for stock pickers, Mr. Rothman says. Though correlations ticked up again in November, they remained well below the levels seen earlier this year, according to Barclays.

Breaking Ranks

Stocks in recent years have often moved in sync, making it tougher for stock-picking money managers to beat the market. But with those correlations breaking down in recent months, analysts see better days ahead for actively managed funds. The chart below shows the average daily return correlation for all pairs of stocks in the Standard & Poor's 500-stock index, on a quarterly basis.



Source: BofA Merrill Lynch Global Research

Active portfolio managers perform best when they operate in inefficient sectors where prices and enterprise value diverge. One of the most inefficient sectors of the market, ripe with inefficiencies (especially coming out of a recession) is the small cap sector. We think that the LSGI portfolio is well positioned in this inefficient sector and should outperform over the coming year – provided history repeats.

- December 24, 2010

