September 30, 2009

Spotlight

Flexible is Beautiful

A volatile market environment demonstrates the need for a nimble, quality-oriented approach to large-cap investing.

The asset management business seems to have lost its way in the last decade or so. After the runaway success of index funds during the raging bull market of the 1990s, more and more active managers—especially large-cap managers—figured it was easier to join them than to beat them. Instead of managing with conviction in their best investment ideas, many active managers have grown increasingly style and benchmark conscious in an effort to not stray too far from the index. Such benchmark awareness may make managers less volatile in a relative sense, but it also makes them less active and less able to add value to a portfolio.

To be sure, the pressure on active managers to conform more rigidly to benchmarks comes in part from the desire for style purity among investors trying to fit a strategy into an overall portfolio. But who is to say that a manager can't do both—fill a particular mandate while still being nimble enough to make active management worth it? To be a viable alternative to indexing, an active manager must add value. To add value, active managers must follow their convictions in finding opportunities even if it may occasionally lead them away from the index.

Absolute Versus Relative Style

TAMRO Capital Partners, subadvisor to the Aston/TAMRO Diversified Equity Fund seeks to do just that with its fundamentals-driven, best-in-class approach to picking stocks. This large-cap strategy is opportunistic in the sense that it doesn't limit itself to a universe defined by an index. Its flexible approach actually reflects an absolute style of management centered on owning quality firms at attractive prices instead of only buying firms limited to a particular benchmark. Indexes change and rebalance, often following the less than rational mood of the market. Even the ubiquitous style box, which many investors use as a basis for allocating assets to various managers, drifts and shifts according to the metrics of the market. Over the years, TAMRO has bucked this relative, benchmark-centric trend in seeking to own the best firms across market sectors and industries.

As difficult as it may be to acknowledge, US large-cap stocks aren't necessarily the leading companies in the world in many industries. For example, few large US companies compete meaningfully in the Materials sector. To invest in large US firms based merely on market-cap or membership in a certain index—or to forgo exposure in that particular industry entirely—would be a disservice to shareholders. While many domestic managers address this problem by looking overseas for such exposure, TAMRO typically prefers to draw upon its experience investing in smaller companies to seek out leaders further down the market-cap ladder. For example, the firm's investment in mid-sized financial stocks recently paid off as those firms weathered the recent financial crisis much better than larger names. Meanwhile, the fund sticks to areas where large US companies typically excel, such as Technology, where large-caps have historically performed better than small-sized firms. [Note: Small- and mid-cap stocks are considered riskier than large-cap stocks due to greater potential volatility and less liquidity.]

Best-in-Class

TAMRO's approach originates with lead manager Philip Tasho, who experienced a market environment of adverse political events, rampaging inflation, and the end of a bull market when he started investing in 1980. He quickly learned that while many firms can succeed when times are good, only a few are able to

survive and thrive during tough economic periods. Today, he and his team of analysts look for firms with proven competitive advantages or those that dominate a particular market niche. Tasho prefers companies with strong management teams, not just the top person, and evaluates the entire leadership structure and the culture it fosters. He believes that it is during the lean periods that management really earns its pay, and he looks for repeatable patterns of behavior on the part of management that enhances shareholder value. Finally, valuation is a key metric, especially in controlling downside risk. As a result, Tasho will only initiate a position in a stock where he believes the potential upside is at least three times the potential downside.

Stocks that combine all three traits—well run firms with significant competitive advantages that also happen to be mis-priced—are difficult to find in practice, however. To root out potential candidates, the team sorts stocks into three distinct varieties—Leaders, Laggards, and Innovators. The truly dominant companies—or Leaders—have qualities largely recognized by the market and typically trade at fair value or a premium, leaving little margin for error. Even these companies, however, are susceptible to short-term setbacks or negative sentiment that can lead to a buying opportunity. It is then that Tasho becomes an interested buyer and, not surprisingly, stocks in this category tend to make up a majority of assets in the strategy. Laggards are generally firms Tasho believes have a solid core business but that have underperformed owing to operational problems and/or poor management. Their share price is already depressed and simply needs a catalyst—often a restructuring led by reinvigorated or new management—to unlock value. Finally, Innovators are companies that share many of the characteristics of Leaders, but tend to be found in more dynamic parts of the economy, particularly Technology, where the successful deployment of research and development dollars is key. With limited opportunities to purchase these types of stocks at attractive valuations, they typically represent 10% or less of assets in the portfolio.

Quality Wins Out

TAMRO's analysts have always looked up and down each industry or sector to find the leaders and assess competitors. Industry analysis and quantitative screens serve to focus their fundamental research efforts. Thus, Diversified Equity is a complement to the Aston/TAMRO Small Cap fund, as the same principles apply up and down the market-cap ladder. Recent market events have led to opportunities further down the market-cap spectrum with the investment team looking to identify "emerging" large-caps and those companies able to sustain operations without relying on external credit amid a difficult lending environment.

By focusing on leading companies able to maintain their competitive advantages, TAMRO is making a bet on quality, not the benchmark. Tasho is less concerned with short-term market swings than he is with delivering strong returns over the long haul. The key to long-term success for such a strategy is to fully know and understand the companies in the portfolio. That emphasis on identifying quality is what investing in large-cap stocks is supposed to be about—well-established firms expected to deliver consistent performance. Although quality is most often found among the largest, most-successful companies, it's wrong to assume that all large-cap stocks automatically represent quality. Quality comes from company fundamentals, not a crude market-cap measure, and by buying strong businesses at attractive prices TAMRO aims to deliver the soundness and constancy that investors expect from a large-cap portfolio.

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