November 2010

Large-Cap Equities:

An Inefficient Market Presents Opportunities for Research-Driven Active Management

INVESTMENT MANAGEMENT

ING

The efficient-market hypothesis dictates that all available and pertinent information is priced into stocks — i.e., a stock's market price at all times reflects its true intrinsic value. From this, it follows that active managers cannot beat the market through stock selection, especially after fees. This hypothesis drives the management and marketing of passive investment strategies, which seek to replicate the performance of a market benchmark.

The concept of efficient markets has gained traction with investors over the years. Financial Research Corporation reports that passively managed products have increased from 8% of assets in 1999 to 19% in May 2009, net of returns and cash flows. However, while that jump is not insignificant, the vast majority of assets — more than 80% — are still invested in active strategies. And for good reason: Most active large-cap managers, for example, are able to outperform the index. Moreover, structural changes in the markets are providing renewed opportunity for asset managers with strong research platforms; those who can best synthesize the available information into actionable investment ideas have a distinct advantage over both passively managed portfolios as well as other active market participants.

Recent trends in the equity markets have resulted in an environment that is particularly constructive for fundamental research-driven active investment managers.

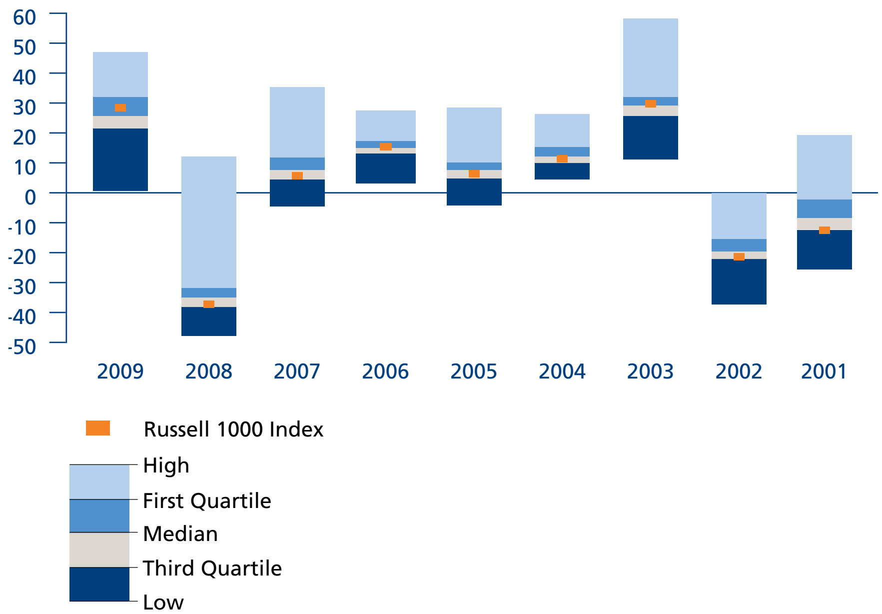
Past and Future both Favor Active Management

In recent years, passive equity managers have attracted a growing share of equity asset flows. Proponents of passive strategies — which include not only index funds but also exchange-traded funds (ETFs) — argue that markets are highly efficient and, therefore, active managers cannot beat markets consistently or over extended periods of time. Empirical evidence, however, suggests that skilled active managers can generate returns in excess of the index and can do so on a repeatable basis. Further, recent trends in the equity markets have resulted in an environment that is particularly constructive for fundamental-research-driven active investment managers.

Performance. Given the oft-cited "advantages" of passive investing, one would assume that benchmark-indexed portfolios would consistently deliver better performance than the majority of active managers; historical data, however, tell a different story. Figure 1 depicts the annual performance of active managers in the large-cap core space each year since 1999, as well as the performance of the benchmark Russell 1000 Index during the same period. As you can see, while the dispersion of performance among active managers can be significant, particularly in volatile markets, the benchmark dependably ranks in the third or fourth quartile. And keep in mind that we are talking about the index here; even the best-run portfolios designed to replicate the performance of an index will naturally come up a few basis points short due to management expenses. Moreover, this performance transcends market environments — for example, a majority of active managers outperformed the benchmark in both the depressed equity market of 2008 and the resurgent 2009 market.

Figure 1. The Benchmark Often Ranks in the Third or Fourth Quartile

PSN Large-Cap Core Universe Quartile Ranking,
Active Managers — Tracking Error Greater Than 2.49%
(December 31, 2000, through December 31, 2009)



Source: Plan Sponsor Network

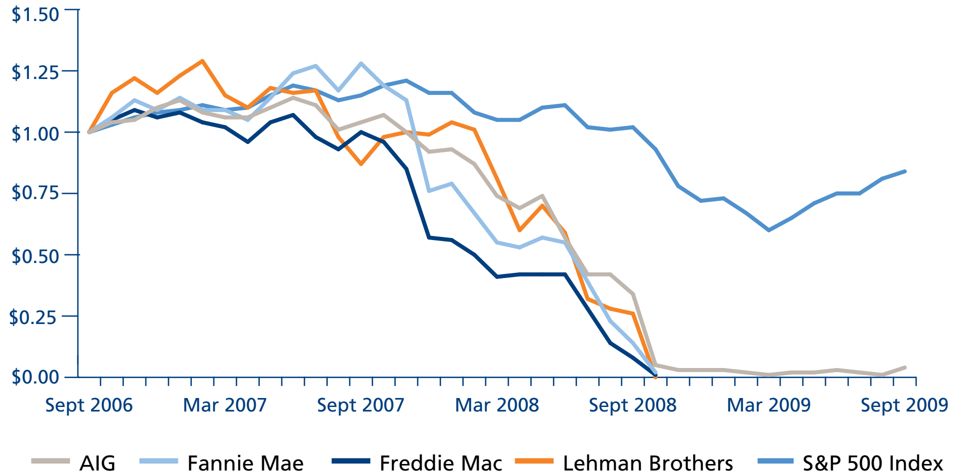
Indexing also forces portfolios to own undesirable stocks and hold large positions in undesirable sectors.

Index Construction. This underperformance is due in part to the way indexes — and, thus, the portfolios that seek to replicate them — are structured. Most major indexes are weighted according to market capitalization, and this bias toward the larger-cap names within an index can result in sub-optimal portfolios in the context of Modern Portfolio Theory (the concept that engendered the efficient-market hypothesis). For example, more than 40% of the weight of the S&P 500 Index can be attributed to less than 10% of the companies within it. As a result, passive equity portfolios are forced to pile into the very largest stocks in an index, further inflating the value of stocks that in many cases are already overvalued.

Indexing also forces portfolios to own undesirable stocks and hold large positions in undesirable sectors. To take one recent example, financials — including such widely held names as Lehman Brothers, AIG, Fannie Mae and Freddie Mac — were pummeled in the wake of the financial crisis. Figure 2 depicts the growth of a dollar investment in these names as well as in the S&P 500 Index from September 2006 to September 2009; as you can see, while the S&P 500 experienced a significant decline over the period, all four individual stocks became worthless or close to it during the same time frame.

Figure 2. Certain Large Stocks Declined Sharply During the Financial Crisis

Growth of $1 (September 2006 through September 2009)

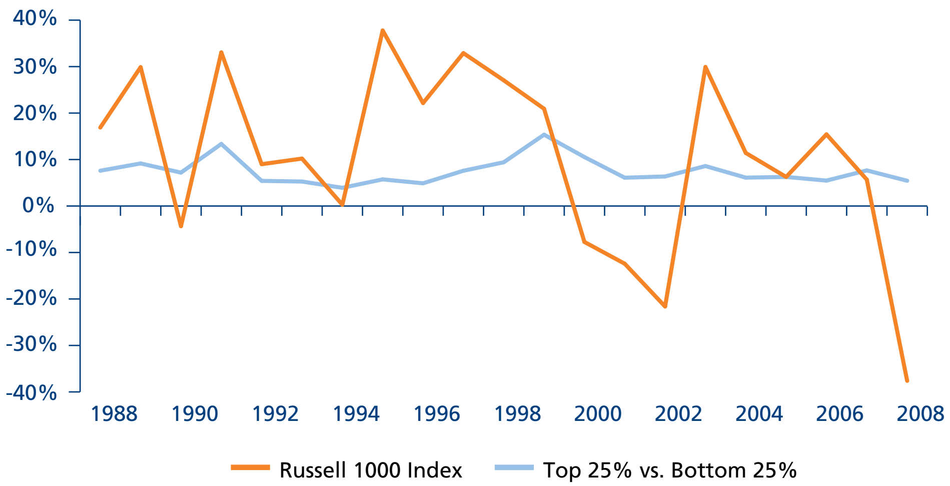


Source: FactSet, ING Investment Management

Forced holdings are particularly damaging given the dispersion of performance — and, thus, opportunity to add alpha — that exists in markets.

These forced holdings are particularly damaging given the dispersion of performance — and, thus, opportunity to add alpha — that exists in markets. For example, for a 20-year period ended in 2008, the average difference in returns between the top 25% of the Russell 1000 and the bottom 25% was about 700 basis points. And as you can see in Figure 3, that level was fairly constant across a variety of market cycles. Thus, active investors that are able to consistently overweight their portfolios in the best-performing stocks while underweighting those in the bottom tier of performance have the potential to add considerable value.

Figure 3. Dispersion in Stock Returns Provides an Opportunity for Active Managers to Add Value



Source: Bloomberg, ING Investment Management

We think equity markets may be more inefficient today than they have been at any point in the last ten to 15 years.

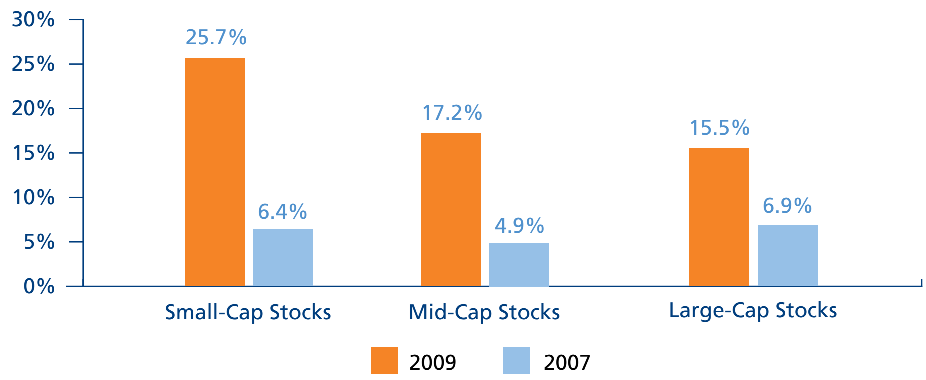
Structural Changes. Beyond the inherent limitations of index construction and the impact it has on the performance of indexed portfolios, current market dynamics are casting serious doubt on the concept of efficient equity markets and creating an environment in which an adept active investor can thrive. In fact, we think equity markets may be more inefficient today than they have been at any point in the last ten to 15 years — meaning that there are many mispriced stocks and thus significant opportunities for managers to employ their stock-selection skills.

Traditionally, Wall Street research was funded by investment banking and trading operations. This business model was turned on its head in the early 2000s, as former New York Attorney General Elliot Spitzer aggressively pursued a series of high-profile lawsuits against some of Wall Street's largest investment banks. Ultimately, a settlement was reached in 2003 that, among other provisions, forced broker/dealers to sever the links between their research and investment banking operations, meaning that costly research platforms could no longer be financed by lucrative investment banking fees. Meanwhile, commission deregulation has driven down the cost of a trade steadily since it was enacted 30 years ago, reducing margins on trading operations.

Of course, the recent financial crisis put even more stress on this already-challenged business model. Our analysis showed that between September 2008 and May 2009, there were around 2,200 instances of analysts dropping research coverage. More than 15% of the analysts tracking large-cap companies stopped providing formal research coverage between 2007 and 2009; the declines were even steeper in the mid- and small-cap spaces, as shown in Figure 4.

Figure 4. Sell-Side Analyst Coverage Has Diminished

Percentage of research reports that announced an analyst has dropped coverage of a stock



Source: *Wall Street Journal*, Goldman Sachs, FactSet, Morningstar

Another bit of fallout from the investment bank decoupling was a reduction in compensation for Wall Street analysts. As a result, many of the top talent went elsewhere — hedge funds, proprietary trading desks, investment managers. Generally speaking, our experience is that today's Street analysts are far less experienced and far less likely to offer unique investment insights. Those analysts who do remain tend to take shorter-term outlooks, catering to the needs of hedge fund managers focused on immediate gratification. In the past, analysts would provide earnings estimates for several years out; now, you're lucky to get them to publish a number several quarters ahead. Fewer, less-experienced eyes with a shorter-term outlook leads to market dislocations and opportunities to uncover value, particularly if you focus on performance over a three- to five-year business cycle.

Fewer, less-experienced eyes with a shorter-term outlook leads to market dislocations and opportunities to uncover value.

Regulation in recent years has also had an impact on the availability of company-specific information. Regulation FD was adopted by the Securities and Exchange Commission in 2000. It was intended to level the playing field between institutional and individual investors by preventing companies from selectively disclosing material non-public information — analysts and large institutional investors would no longer have access to information that the average individual investor lacked. However, we've found that it's made public companies gun-shy; instead of providing extensive information to the entire market, more and more companies are declining to give any guidance at all or they are giving it less frequently. This has been especially true in the current uncertain market environment. Unilever, Ford, Berkshire Hathaway, AT&T and Safeco are among the large public companies that have announced they will no longer be providing earnings guidance.

Meanwhile, the financial crisis has thinned the ranks of hedge funds — many of which promote market efficiency by quickly arbitraging away inefficiencies. There have been hundreds of hedge fund closings over the past two years. And we saw 7% fewer 13F filings (a quarterly filing with the SEC that is required of "institutional investment managers" — i.e., those with assets under management in excess of $100 million) by hedge funds in second quarter 2009 versus second quarter 2008. Hedge funds that are still around are taking smaller positions and employing less leverage, thus having less of an impact on the market.

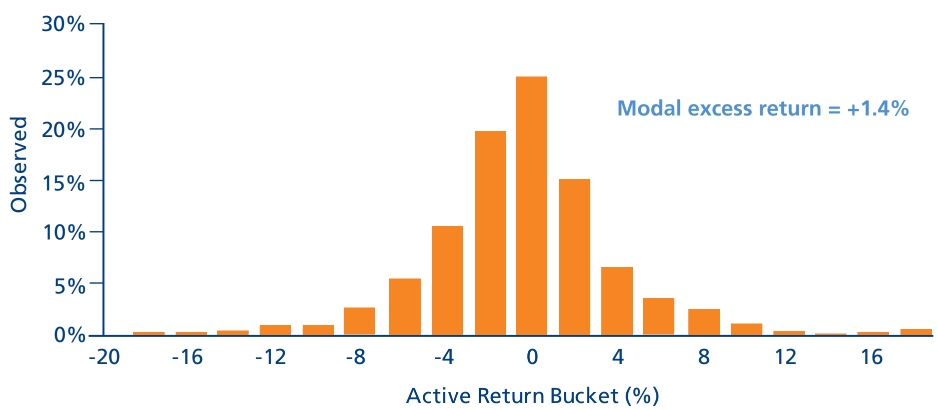
Fundamental Research Is Key to Unlocking Opportunities

While the potential that exists within active management is evident, identifying the managers possessing the skills necessary to deliver on this potential remains a significant challenge for investors. To illustrate this point, we examined the Morningstar database of more than 6,000 funds as a proxy for the universe of potential active managers. To capture the skill of each, we looked at the excess returns of these portfolios relative to their benchmarks over a three-year period. Figure 5 depicts the distribution of returns for these active mandates as a group. We note that while the modal excess return of active managers — that is, the return occurring most frequently in the series — is 1.4% during the sample period, there is a distribution of good and bad active managers, and that the distribution has fat tails. Hence, while it is plausible to state that active management adds value above a benchmark, the individual experience of an investor can vary greatly based upon the actual active manager selected and the sample period.

Identifying the managers possessing the skills necessary to deliver on this potential remains a significant challenge for investors.

Figure 5. Good and Bad Managers Are Widely Distributed

Distribution of three-year excess returns of active managers (April 1, 2004, through March 31, 2009)

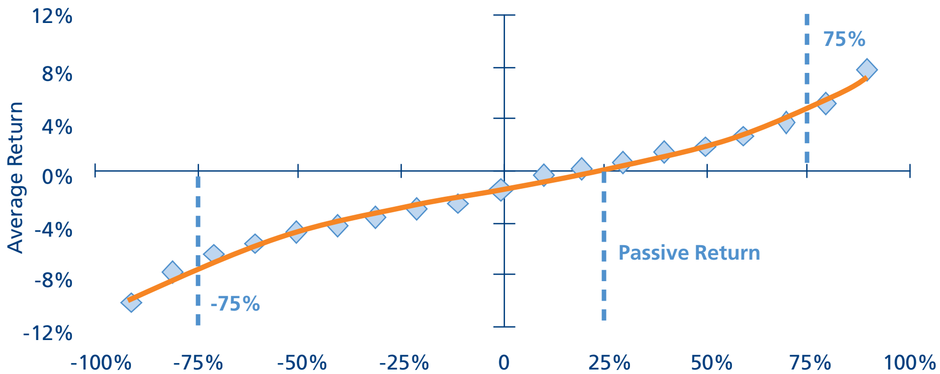


Source: ING Investment Management

In Figure 6 we show the impact that manager selection can have on excess return. As selection skill increases, so too does the excess return achieved; as we move to the right on the graph, the least-successful managers are progressively removed from the manager universe. An investor able to narrow its choice of active manager to within the top quartile would have achieved a three-year excess return of about 4.5%. Conversely, as we move to the left side of the graph, manager selection grows increasingly poor (represented by removing the best managers from the manager universe). An investor able to select only from managers in the bottom quartile of performance would have achieved an excess return of about -7.0%. As you can see in the graph, an investor skilled enough to select a strategy in at least the top 75% of the manager universe will be better served by being active rather than passive. Further, the better an investor is at manager selection (thus moving further right along the curve), the larger its allocation to active investment should be relative to passive indexation.

Figure 6. Manager Selection Makes a Huge Difference

(April 1, 2004, through March 31, 2009)



Source: ING Investment Management

So what should investors look for in pursuit of top-quartile active managers? Given the dynamics we described earlier and the less efficient market that has resulted, we believe investors would be well served by seeking out managers with robust fundamental equity research platforms. In many ways, successful investment managers will be the ones best able to fill the research void left by the sell side — making sense not only of individual companies and stocks, but also the industries in which they operate and the market trends that may favor or penalize individual names.

We believe investors would be well served by seeking out managers with robust fundamental equity research platforms.

Conclusion

The boom-and-bust cycles in the financial markets in recent years should convince investors that markets do not always behave "rationally". And given the market trends we discuss in this report, it appears likely that the pendulum will swing back in favor of active management.

That said, many active managers will fail to beat their benchmarks. This isn't an indictment of the concept of active management; rather, it speaks to the importance of manager selection. Going back to 2003, top quartile large-cap equity managers have delivered 10% more alpha than the bottom-quartile managers on an annual basis and 7% on a rolling three-year basis; investors able to choose managers in the top quartile stand to pick up a significant amount of return in excess of the benchmark. We believe that in the current environment, the top-performing managers will be those best equipped to perform the exhaustive fundamental research necessary to uncover the best investment opportunities.

ING Investment Management • 230 Park Avenue • New York, New York 10169

WWW.INGINVESTMENT.COM

BSWP-FUNDEQUITY (1110-110110 ex013111)