Perspectives℠

LEGG MASON
GLOBAL ASSET MANAGEMENT

Legg Mason Capital Management Active vs. passive debate:

Active strategies can add value but managers must be disciplined, unconstrained, and truly active.

Executive summary

Although active managers have on average failed to beat their benchmarks consistently over time, studies show that active management provides investors with an opportunity to add value over long-term periods, provided that the managers are disciplined, unconstrained, and truly active. Moreover, due to narrowing valuation spreads, one could argue that the stage is being set for a multi-year period of strong relative performance for active managers. According to research by State Street's Mark Kritzman and Sebastian Page, security selection is the most important of the typical investment choices that investors make, as it offers the greatest room for active managers to add value above the average performance. Thus the opportunity exists for active managers to add value for their clients.

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In our view, managers' inability to consistently beat the benchmark over time is more a result of the defects in their portfolio management than it is an indictment of active management in general. Looking at certain characteristics of the S&P 500 provides a case study into which traits make active management successful, in our view. Among what we deem to be the successful traits demonstrated by the S&P 500 are a long-term horizon, low turnover, tax efficiency, and a buy and hold strategy. Historically, the Index has let its "winners run" and never sells a successful investment simply because it has appreciated. In addition, it does not impose size or position limits arbitrarily on holdings, either by company or industry. This stands as a stark contrast to many active managers, who demonstrate a short-term focus, high turnover, and rigid constraints using somewhat arbitrary measures such as position limits or systematically reigning in winners.

In addition to being unconstrained, a manager must also be truly active. Empirical evidence suggests, unfortunately, that many managers claiming to be active managers behave like closet indexers. In a 2007 paper, Yale University's Martijn Cremers and Antti Petajisto developed a metric called "Active Share" to measure how much a portfolio is truly different from a benchmark. Based on their research, they found that the funds with the highest Active Share significantly outperform their benchmark indexes both before and after expenses, while the non-index funds with the lowest Active Share underperform. Furthermore, the two researchers also found that the most active stock pickers tend to create value for investors while factor bets and closet indexing tend to destroy value.

As part of Legg Mason Capital Management's philosophy and process, we apply a long term, low turnover, buy and hold strategy that allows our investment ideas to fully develop. Additionally we believe that a concentrated portfolio designed with a variant perception or "Active Share" is critical to long term success. Lastly, after *identifying compelling opportunities in individual securities using the approach outlined above, we construct portfolios designed to generate the highest level of risk-adjusted returns.*

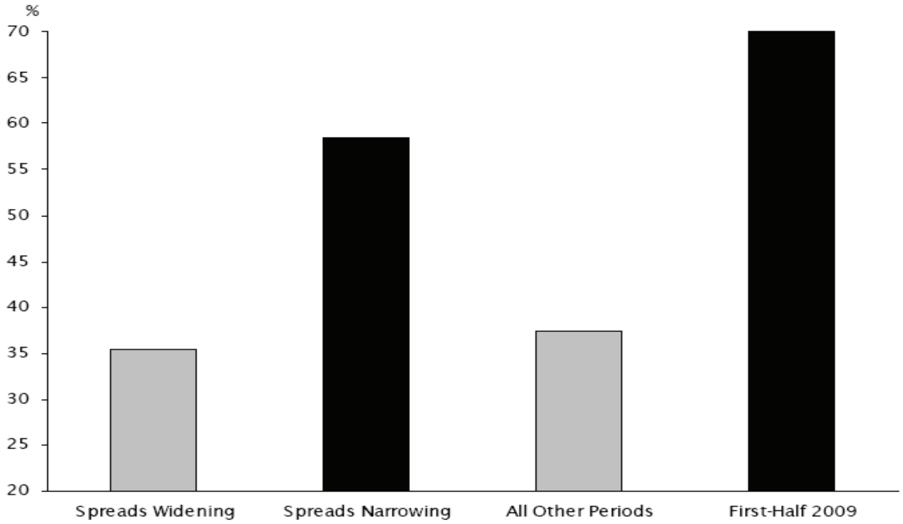
Now is a great time to be active as valuation spreads narrow

Based on empirical data, the present environment is shaping up to be a good one for active managers – especially those that employ valuation strategies. According to Empirical Research Partners, active managers tend to do well early in stock market cycles when it is obvious what areas of the market are cheap and there is growing evidence that earnings growth is poised to resume.

This trend is particularly prevalent when the spread between the most expensive quintile of the market and the least expensive is narrowing, as it is now. As shown in the chart on the next page, during periods where valuation spreads are narrowing, nearly 60% of mutual funds[1] outperform the S&P 500 Index, while only 35% outperform when valuation spreads are widening. This trend seems to be holding up so far this year, as approximately 70% of equity funds beat the S&P 500 Index over the first six months of the year. Based on this data, Empirical argued that we are in the beginning stages of a multi-year run of strong relative returns for active managers.

[1] Mutual fund universe includes all funds that Lipper classifies as domestic general equity funds.

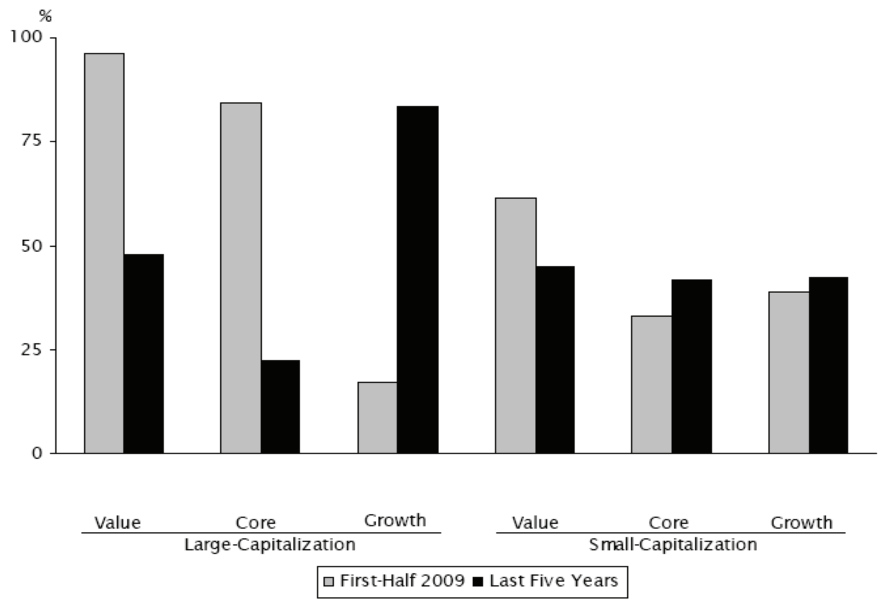
Share of general equity funds outperforming the S&P 500



Source: Empirical Research Partners

Moreover, according to Morningstar, this trend of active management outperformance so far this year tends to be more concentrated in value and core strategies than in growth strategies. As shown in the chart below, over 70% of large-cap strategies that are evaluated against value and core bench-marks outperformed, while only one in six growth managers beat their style benchmarks.

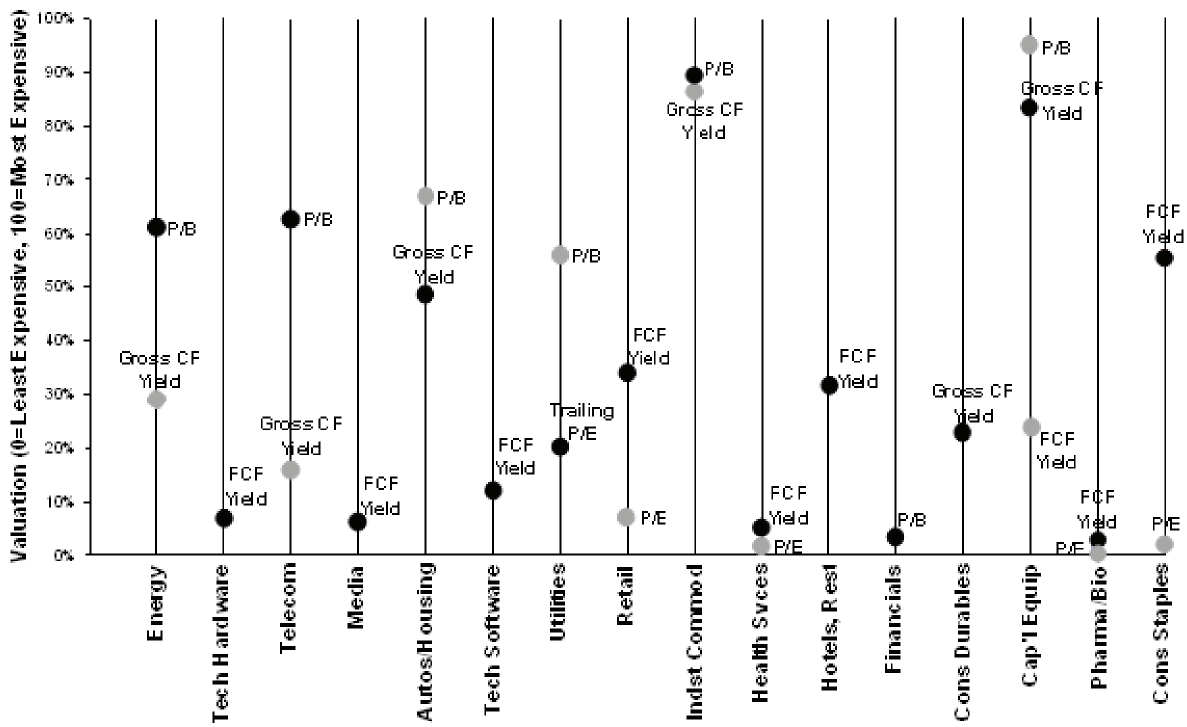
Share of actively managed funds outperforming their style indices



Source: Morningstar, Empirical Research Partners

This data supports what we are seeing with intra-sector valuation spreads, a measure of value opportunities, which are at levels that, in many cases, suggest an above-average abundance of opportunity. The widest disparities (of 90% or greater) exist in the battered Financial sector, as well as Pharmaceuticals-Biotechnology and Consumer Durables, but spreads remain elevated in every sector save for Retail, Media & Consumer Services and Industrial Commodities. In addition, as shown on the next page, most sectors are close to the least expensive end of the historical distribution by the most relevant valuation metrics.

Most sectors are attractively valued relative to history

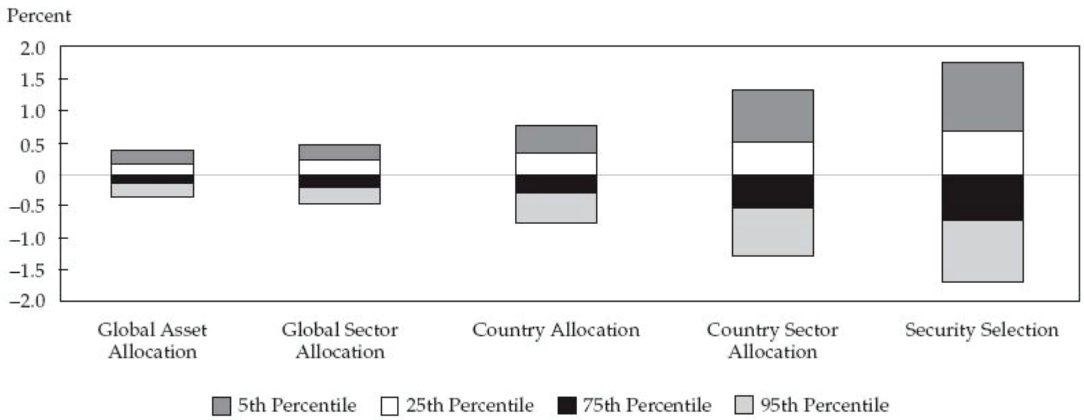


Source: BCA Research, as of September 2009. Legend: CF (Cash Flow), FCF (Free Cash Flow), P/B (Price-to-Book), P/E (Price-to-Earnings). Gross CF Yield is cash produced by recurring operations (cash from recurring operations is calculated by adding depreciation, amortization, and changes in deferred taxes to net income) over the trailing four-quarters divided by the market value of equity. FCF Yield is calculated by starting with gross Cash Flow and subtracting capital expenditures net of the proceeds of the sale of property, plant and equipment. Outflows related to cash mergers are excluded from the analysis as are financing activities. To get the FCF Yield, divide FCF by the market value of equity. P/B ratio is a stock's price divided by the stocks per share book value. P/E ratio is a stock's price divided by its earnings per share. With regards to the colors used in the illustration, those items marked with a black dot are meant to indicate the "key" valuation metric (based on BCA Research/Empirical Research's opinion) for that sector. This is the metric that Empirical Research/BCA Research has found most directly explains future performance for a sector over time in terms of both the quantity and reliability of those returns. Note that the "key" metric often varies from sector to sector. Those items marked with gray dot(s) are used to indicate all other metrics Empirical/BCA Research indicates that are not the "key" metric for that sector. Please note that the information above is based on analysis of industry sectors by BCA Research as of September 2009. The chart, based on analysis of data starting in 1952, reflects where key fundamental metrics such as cash flow, free cash flow, price-to-book and price-to-earnings fall in comparison to historical averages. For purposes of this illustration, the range is 0% being least expensive from a valuation standpoint, with 100% being most expensive from a valuation standpoint. *Past performance is no guarantee of future results.*

Active management has best ability to add value over long term

In 2003, State Street's Mark Kritzman and Sebastian Page[2] set out to determine whether asset allocation was indeed the most important decision an investor can make, as is commonly believed. They started with the question, "Of the typical investment choices that investors make, which one has the biggest potential impact on portfolio performance (and therefore should be investors' top priority to get right)?" Their finding is summarized below:

Percentile performance over horizon: Annualized difference from average, 1987-2001[2]



The above chart convincingly shows that contrary to perceived doctrine, dispersion around average performance arising from security selection is the greatest, indicating it is the most important investment choice. That is, active management matters. On the other hand, asset allocation, which is widely considered the most important investment choice, produces the least dispersion; thus, from a normative perspective, a passive management regime that only taps into asset allocation does not afford much room to add value.

Unconstrained, disciplined approach is necessary for active managers

If active management has the best potential to add value, why then do so few active managers deliver on that promise? We believe this has more to do with the defects in most active managers' portfolio management practices than with active management itself. Active managers too often ignore trading costs, market impact costs, and taxes when managing their portfolios, and they are plagued by cognitive errors in decision making, such as overweighting recent data and anchoring too tightly on irrelevant criteria.

By contrast, what makes the S&P 500 Index such a formidable benchmark for active managers is its portfolio management philosophy. The S&P 500 is a long-term oriented, low turnover, tax efficient portfolio that employs a buy and hold strategy. It lets its winners run and selectively eliminates its losers. It never sells a successful investment no matter how far it has appreciated, and it does not impose size or position limits arbitrarily on holdings, either by company or industry. Periodically, new names are added and others eliminated to replace companies that are marginal with those that are deemed to have a more important position in the economy or their industry. The portfolio is also positioned to represent a broad sweep of the US economy, filled with seasoned companies with a history of profitability, financial soundness, market or industry leadership, and that have a probability of being in business in the next 10 to 20 years.

[2] Source: Based on data from Mark Kritzman and Sebastian Page, "The Hierarchy of Investment Choice," *Journal of Portfolio Management* (Summer 2003: 11-23). http://www.northinfo.com/documents/136.pdf

The strategies of the S&P 500 Index contrast sharply with the typical active manager. In our view, many active managers are short-term oriented, tax inefficient, and have high turnover due to an overemphasis on trading. Most funds systematically cut back winners or rotate out of stocks that have done well into those expected to do better. Position limits are rigidly maintained in the name of investment discipline or risk management.

We believe the S&P 500 beats most managers because it has a superior strategy. As the market is generally efficient, trying to add value to the benchmark by trading excessively requires you to be right on both sides of the trade to deliver a superior return. The more you trade, the harder it becomes, creating a dynamic where you have to be able to systematically obtain short-term information superior to what the market in the aggregate knows — what we believe is a loser's game. The way to win is to not play the information game and instead analyze business value and invest for long enough for that value to play out — the S&P 500's strategy. As new information arrives unpredictably and the market is generally aware of the information that may affect the prospects of its constituent companies over the near term, trading on information versus investing based on long-term analysis is just hard to win.

"Activeness" predictive of performance

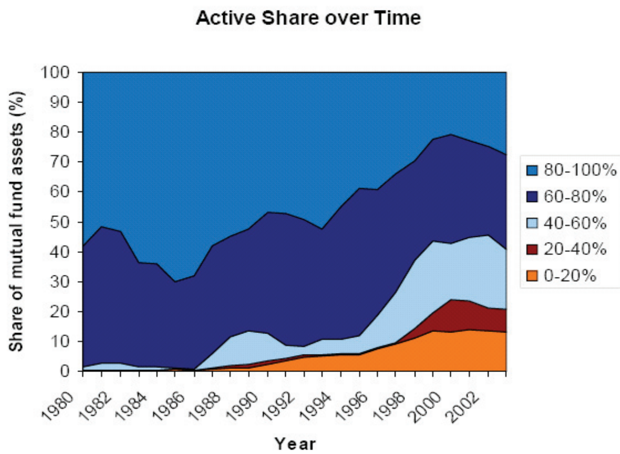
The "activeness" of a manager has been shown to predict the performance of managers over time. A study by Yale University's Martijn Cremers and Antti Petajisto[3] argues that tracking error, a widely used measure of a portfolio's "active risk," does not tell the whole story about how active a portfolio is, or in what way. In their paper, the two professors proposed a measure dubbed Active Share[4], which describes the share of portfolio holdings that differ from the portfolio's benchmark index. By combining Active Share and tracking error, we have a two-dimensional space to examine a portfolio's "activeness," as shown in the chart below.

The addition of the Active Share dimension to the traditional metric of tracking error allows us to distinguish between four common investment strategies employed by active managers. A *diversified stock picker* can actually be very active despite low tracking error, because stock selection within industries can still lead to large deviations from the index portfolio. In contrast, a fund taking systematic *factor bets* can generate a large tracking error even without large deviations from index holdings. A *concentrated stock* picker combines the two approaches, thus taking positions in individual stocks as well as systematic risk. Finally, a *closet indexer* scores low on both dimensions of active management while still claiming to be active.

In addition to this metric, Cremers and Petajisto also examined a large sample of 2,650 all-equity mutual funds during the period from 1980 to 2003. The two researchers found that active management predicts fund performance: the funds with the highest Active Share significantly outperform their benchmark indexes both before and after expenses, while the non-index funds with the lowest Active Share underperform. Furthermore, they also found that the most active stock pickers tend to create value for investors while factor bets and closet indexing tend to destroy value.

3 Cremers, Martijn and Antti Petajisto, "How Active Is Your Fund Manager? A New Measure That Predicts Performance," Yale University working paper. http://www.som.yale.edu/Faculty/petajisto/active50.pdf

4 Active Share = $\frac{1}{2}\sum_{i=1}^{N}\left|w_{fund,i} - w_{index,i}\right|$ where N is the number of securities in the universe (including both the index and the fund portfolio). We can decompose an active portfolio into a 100% position in the benchmark index, plus a zero-net investment long-short portfolio, which represents all the active bets. Active Share then measures the size of that long-short position as a fraction of the total portfolio of the fund.



Source: Cremer & Petajisto

We find the above insight particularly thought provoking in the debate of active versus passive management. It suggests that perhaps the problem with active management is not that we have too much of it — maybe the problem is that many active managers are not truly active. The chart on the left shows the trend among the investment strategies adopted by active managers. Given the disconcerting trends, one wonders whether active managers' dysfunctional behaviors may have aggravated their performance problem.