2010 Review

Lyrical Asset Management produced another excellent year in 2010. Our composite portfolio generated a gross return of 25.0%, compared to 15.1% for the S&P 500 and 15.5% for the Russell 1000 Value.

	2009	2010	ITD
Lyrical Asset Management (Gross)	+80.2%	+25.0%	+125.2%
Lyrical Asset Management (Net)	+68.4%	+22.3%	+106.0%
S&P 500 (Total Return)	+26.5%	+15.1%	+45.5%
Relative Performance (Net)	+4,190 bp	+720 bp	+6,050 bp

The drivers of our returns again were broad based, as 82% of the stocks in the portfolio had a positive return on the year, and 73% of the stocks in the portfolio outperformed the S&P 500.

LOOKING BACK

Much of 2010 seemed to be ruled by macroeconomic headlines, driving correlations among stocks to historical highs. The macro winds gave rise to a very choppy market over the course of the year. The year started strongly with a rally into April. Then May and June were very weak, followed by a strong July, a weak August, and ultimately a very strong September and fourth quarter. For short term, trend following investors, this had to be a challenging year. As soon as one trend in the market was established, it quickly reversed. But that's their problem, not ours. We are patient, long-term investors and shrug off these up and down market moves. We invest in stocks trading with some of the deepest discounts to intrinsic value and hold them until they approach a fair price. A 10% move in the market hardly seems significant compared to the 65% average upside we currently see in our investments. Our patience is reflected in our light trading activity. During 2010 our portfolio turnover was just 23.7%, comparable to our low 2009 turnover.

It is ironic that there has been so much fear of the macro while there has been such strength in the micro. On average, earnings reports from companies this year consistently exceeded expectations. According to FactSet, at the start of 2010, consensus expectations for 2010 S&P500 earnings were $71.44. Now, at the end of the year, it appears earnings will be 17% higher than expected, at $83.25. The recovery in many macro statistics such as GDP or employment may be muted, but the recovery in corporate profits continues to be strong, and, as holders of equities, we own the residual claim on these improving profits.

The explanation for the disconnect stems perhaps from low expectations for future economic growth, the so-called "new normal." In the past, low expectations have actually been a good thing for equity investors. It is not whether results are strong or weak that is important; rather, it is whether results are stronger or weaker than what is expected that drives future returns. Hence, lower expectations offer greater potential for prospective returns.

LOOKING FORWARD

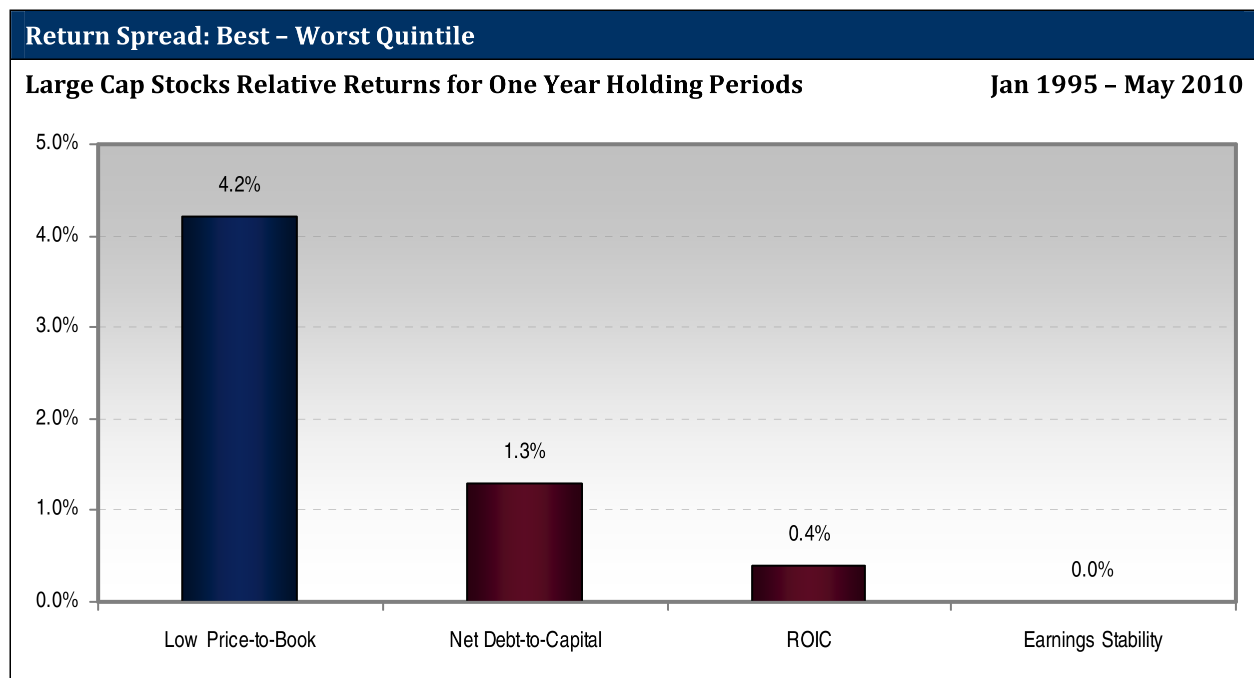
We continue to have very high return expectations for our portfolio. Only in 2008 and 2009 have we seen fundamental values more attractive. We believe our current portfolio is on par with portfolios we owned in early 2000 and early 2003, each of which produced excellent absolute and relative returns. While the majority of our conviction comes from a bottom up view of the stocks we own in the portfolio, we gain additional comfort when we look at the history of value cycles. Over the past fifty years, the shortest up-cycle for deep value lasted about five years (October 1990 to August 1995), and one lasted for as long as fifteen years (June 1973 to August 1988). It has been only 22 months since the current up-cycle for deep value investing started in March 2009. If the past fifty years are any guide, we should witness several more years of prosperity for deep value investing strategies.

QUALITY and VALUE

In our 2009 review letter, we discussed the impressive performance history of deep value investing, using the lowest price-to-book quintile of the top 1000 stocks as a proxy. The compelling evidence of that history explains why we are deep value investors. However, there is much more to our investment approach than just buying the cheapest companies in our universe. While some value investors will consider buying any business if it is cheap enough, at Lyrical we only invest in those companies that are also quality businesses.

Quality, like valuation, might seem to be in the eye of the beholder, but we are manifestly fact-based in our approach. Thus, we define quality as a business that (1) should generate an attractive double-digit return on invested capital, (2) has a prudent balance sheet without excessive leverage, and (3) exhibits reasonable earning stability (*i.e.*, is not excessively cyclical).

While it makes intuitive sense that quality companies should be good investments, analysis of this most basic claim proves otherwise. Deep value investing, using price-to-book as a proxy, has generated far greater returns than quality investing, using net debt-to-capital, ROIC, and earnings stability as proxies. This is why we are first and foremost deep value investors.

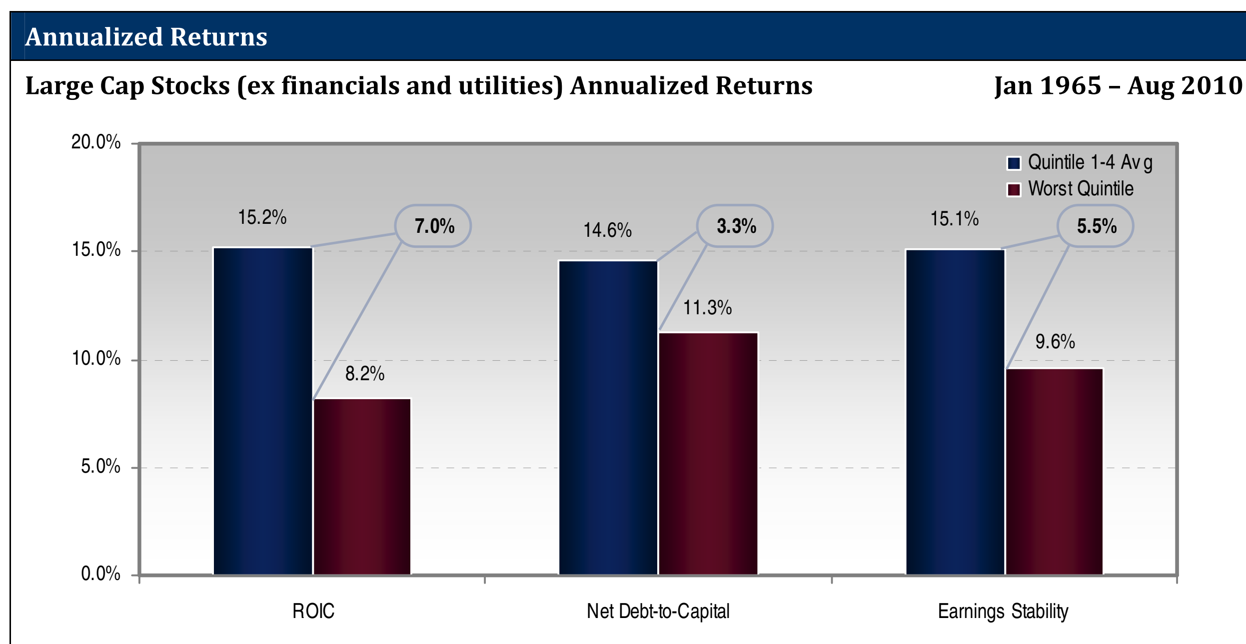


Source: Empirical Research Partners; Pzena analysis

However, applying quality factor criteria to just the subset of cheap stocks generates a very different and more robust result. Within the cheapest price-to-book quintile, avoiding stocks with the lowest quality metrics has produced superior returns. Quality works but only within a deep value investing approach.

Annualized Returns

Large Cap Stocks (ex financials and utilities) Annualized Returns **Jan 1965 – Aug 2010**



Source: Empirical Research Partners; Pzena analysis

WHY DOESN'T EVERYBODY DO THIS?

The data on deep value investing is notably compelling, and the premise of buying quality companies is easy to like. Why, then, do so few investors follow the approach of owning deep value stocks of good businesses? While we cannot answer for other managers, we see a few obstacles for others to follow this approach. Firstly, value investing is emotionally difficult. It is much more fun to own companies that everyone likes. Unfortunately, that approach usually does not lead to superior returns. If you look at the Lipper universe of 6,500 US Equity mutual funds for 2010: 47% were Core, 34% were Growth, and only 18% were Value. So, *a priori*, 82% of funds have rejected value investing. This percentage would be even higher if you included those funds that pursue watered-down value approaches instead of deep value. True deep value investors are a rarity.

Among deep value investors, it is rarer still to find those that also are selective about business quality. If you start with our universe of the top 1000 stocks and want to own those in the bottom quintile of valuation, you are down to about 200 stocks from which to choose. Now if you also want to be selective about quality you may be left with less than 100 from which to choose. Demanding low valuation and good quality severely restricts your set of opportunities. Furthermore, constructing a portfolio around these proven, but restrictive criteria makes it nearly impossible to resemble a benchmark or restrain tracking error.

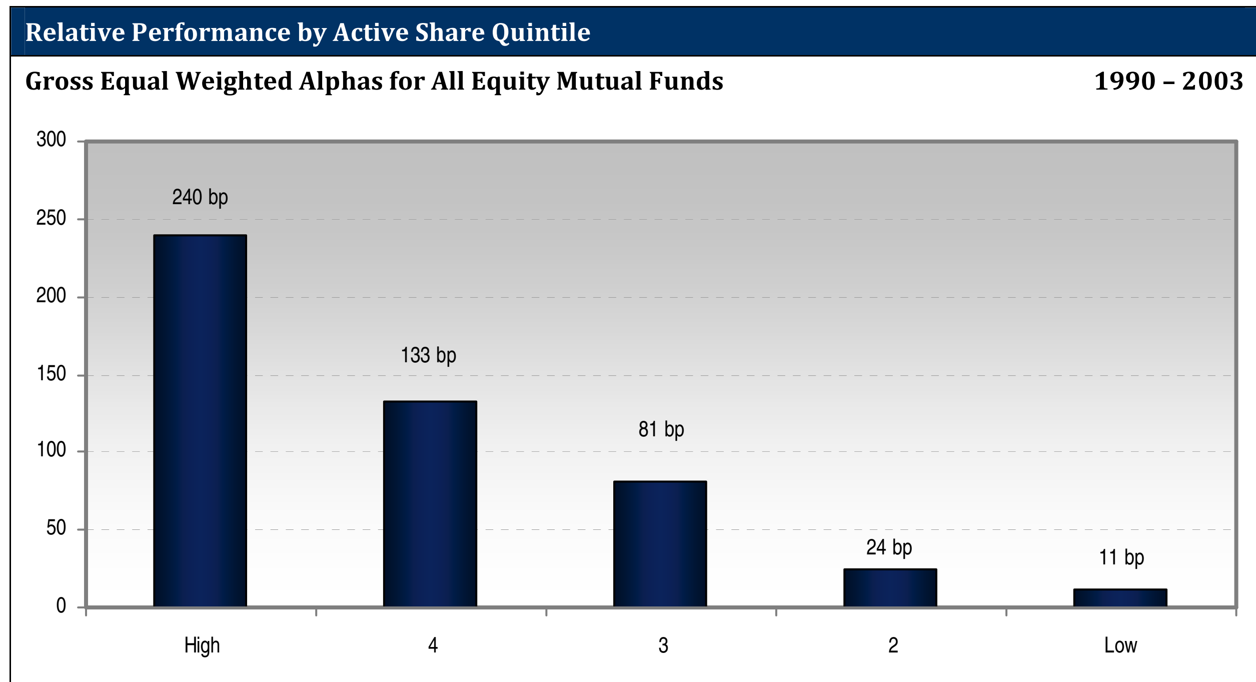
THE RISE OF BENCHMARKING

In the world of long-only investing, benchmarks are a big deal. A paper published in March 2009 by the Yale School of Management titled "How Active Is Your Fund Manager? A New Measure That Predicts Performance" examines the history and performance of mutual funds and how actively or passively those funds are managed relative to benchmarks. The study includes over 2,600 funds and covers over 20 years of data from 1980 to 2003. The centerpiece of Yale's research is a metric called Active Share, which measures the percentage of a fund's portfolio that deviates from the best fit benchmark. Thus, an Active Share measure of 0% means the portfolio is a clone of the benchmark, while a measure of 100% means there is no overlap with a benchmark at all. Furthermore, they define funds with Active Share <20% as pure index funds, those with 20-60% as "closet" indexers, and those >60% as true active managers.

Today (or at least in 2003, the last year in the study) 44.8% of the funds are index (15.3%) or "closet" index (29.5%). But it wasn't always this way. In fact, for most of the 1980s only 1-2% of the funds were index or "closet" index. Thus, active managers have declined from being 98% of the population to just over 50%. Highly active managers, those with Active Share over 80%, have declined from 42.3% in 1980 down to just 23.3% in 2003.

ACTIVE SHARE = SUPERIOR RETURNS

So what! Is being more like the benchmark indices a bad thing? Well, that depends on whether you want low tracking error or high returns on your capital. If you want returns, being a "closet" index fund is not a good way to go. The study by the Yale School of Management clearly shows that among active funds, those with the highest active share perform the best relative to their benchmarks.



Source: Cremers, K. J. and Petajisto, A., 2009, "How Active Is Your Fund Manager? A New Measure That Predicts Performance" *Yale School of Management*, Table 5.

The active share of our portfolio is very high. While 57% of our stocks are members of the S&P 500, and 77% are members of the Russell 1000, our estimated Active Share relative to either of those indices is 97% due to the low weights most of our stocks have in the benchmark indices. An Active Share measure of 97% would put us near the top of the top quintile in the Yale study. Like true deep value investors, managers with an Active Share this high are also a rarity.

CONCLUSION

In our 2009 letter we provided evidence why we believe a deep value strategy is a highly effective approach to long term investing. In this letter, we provide additional rigorous analytical data to support our quality approach to deep value, and our high Active Share portfolio construction.

At Lyrical Asset Management we like to say that our approach is engineered for success. We have extensively studied what works in investing and have built our product around these principles. We focus on value, we focus on quality, and we avoid influence from benchmarks. We do this because it has been proven in the past to drive superior returns, and we expect this to continue into our future.

Andrew Wellington,
Managing Partner
Chief Investment Officer

THIS IS NOT AN OFFERING OR THE SOLICITATION OF AN OFFER TO INVEST IN THE STRATEGY PRESENTED. ANY SUCH OFFERING CAN ONLY BE MADE FOLLOWING A ONE-ON-ONE PRESENTATION, AND ONLY TO QUALIFIED INVESTORS IN THOSE JURISDICTIONS WHERE PERMITTED BY LAW.

THERE IS NO GUARANTEE THAT THE INVESTMENT OBJECTIVE OF THE STRATEGY WILL BE ACHIEVED. RISKS OF AN INVESTMENT IN THIS STRATEGY INCLUDE, BUT ARE NOT LIMITED TO, THE RISKS OF INVESTING IN EQUITY SECURITIES GENERALLY, AND IN A VALUE INVESTING APPROACH, MORE SPECIFICALLY. MOREOVER, PAST PERFORMANCE SHOULD NOT BE CONSTRUED AS AN INDICATOR OF FUTURE PERFORMANCE.

THE S&P 500 INDEX IS A MARKET CAPITALIZATION WEIGHTED INDEX COMPRISED OF 500 WIDELY-HELD COMMON STOCKS.

THE RUSSELL 1000 VALUE INDEX MEASURES THE PERFORMANCE OF THE LARGE-CAP VALUE SEGMENT OF THE U.S. EQUITY UNIVERSE. IT INCLUDES THOSE RUSSELL 1000 COMPANIES WITH LOWER PRICE-TO-BOOK RATIOS AND LOWER EXPECTED GROWTH VALUES. THE RUSSELL 1000 VALUE INDEX IS CONSTRUCTED TO PROVIDE A COMPREHENSIVE AND UNBIASED BAROMETER FOR THE LARGE-CAP VALUE SEGMENT. THE INDEX IS COMPLETELY RECONSTITUTED ANNUALLY TO ENSURE NEW AND GROWING EQUITIES ARE INCLUDED AND THAT THE REPRESENTED COMPANIES CONTINUE TO REFLECT VALUE CHARACTERISTICS.