Lyrical ASSET MANAGEMENT

2009 Review

By all accounts 2009 was an outstanding year. Our composite portfolio produced a gross return of 80.2% compared to 26.5% for the S&P 500 and only 19.7% for the Russell 1000 Value.

Performance attribution was robust with 80% of our investments producing a gain. Incredibly, the average position gain was 120% while our losing positions averaged a 17% loss. Compared to the S&P 500, 65% of our investments outperformed with an average margin of outperformance of 120%, while the 35% that underperformed trailed on average by 22%. Our trading activity was light this year and portfolio turnover was 19%.

LOOKING BACK AT 2009

The year started out rough as we were down almost 19% at the end of February and declined more in early March. The S&P 500 and Russell 1000 Value benchmarks had performed the same or worse. Fear was rampant and valuation irrelevant. Our universe of value stocks was the cheapest we had ever seen, and it kept getting cheaper. This was not the way we wanted to start the year. This was a very scary environment, but also one rich with opportunity. We held firm.

Our portfolio consists of roughly 35 stocks invested at a 3% position weight or lower. The portfolio is constructed to be as balanced and diverse as possible, and by policy and design we avoid concentration risk. No industry may be more than 10% of the portfolio at cost. While we are deep value investors, we also require our investments to be good businesses, generally capable of producing double-digit returns on invested capital. Furthermore, we only invest in businesses that we can properly research, analyze and understand. All of these elements, from investment philosophy to security selection to portfolio construction, played a critical role in our ability to hold firm during those times of uncertainty and fear. Simply put, we knew in our best judgment that we owned good businesses at great prices in many different industries and sectors, and that while all might not recover from this crisis most would.

The market started to turn around on March 6, 2009 although the fundamental economic evidence to support that turnaround would not surface until weeks and months later. Over the last ten months of 2009 our portfolios appreciated over 122% while the S&P 500 and Russell 1000 Value increased 55% and 56%, respectively. This performance is the result of applying a proven, disciplined investing approach to an extraordinary and unprecedented environment.

A HISTORICAL PERSPECTIVE

For deep value investors like us, we do not regard the Russell 1000 Value index as a real value index. Russell forces every stock of the base index into either the Growth or Value index, thus diluting the impact of the deep value stocks in the Value index with many more that are at or near market multiples. For us, a better benchmark for tracking the performance of a deep value approach is an equal weighted index of the lowest price-to-book (P/B) companies. While the Russell 1000 Value index has 30 years of history, we have been able to get our hands on a 50 year history of a Low P/B series. Looking at the returns of this Low P/B series helps put our results in a better relative and historical context. For example, while our 80.2% gross return this year stands out compared to the 19.7% return of the Russell 1000 Value, it looks more in line when compared to the 60.0% return produced by the Low P/B series.

We have looked at twelve month rolling returns of the Low P/B series going back 50 years to the start of 1960, giving us a total of 588 (49 years * 12 months) periods to examine. As extraordinary as the 60% return for the Low P/B series in 2009 may seem, it only ranks 13th best among the 588 periods. The twelve months ended November 2009 produced a 66% return, ranking it the 8th best. The three best rolling twelve month periods all ended in 1983, with the one ended July 1983 producing 81% - the highest return of the series. Other periods that have outperformed 2009 ended in 1975, 1991 and 2004. So 2009 has been among the best years for deep value, but there have been better.

When we look at the worst years for deep value, 2008-2009 dominates the list. In fact, the nine worst rolling twelve month returns all ended between September 2008 and May 2009. The worst twelve month return for

Low P/B is the period ended February 2009 producing a 54.8% decline. Before 2008-2009 the worst twelve month return was -33.2% in 1990 and -31.2% in 1974. So, while the gains seen this year are rare but with precedence, the losses of 2008 and early 2009 for deep value are by far the worst witnessed in the last 50 years. Given that 2009 was coming off the worst period in 50 years for deep value investing, the strong positive results for the year appear less surprising.

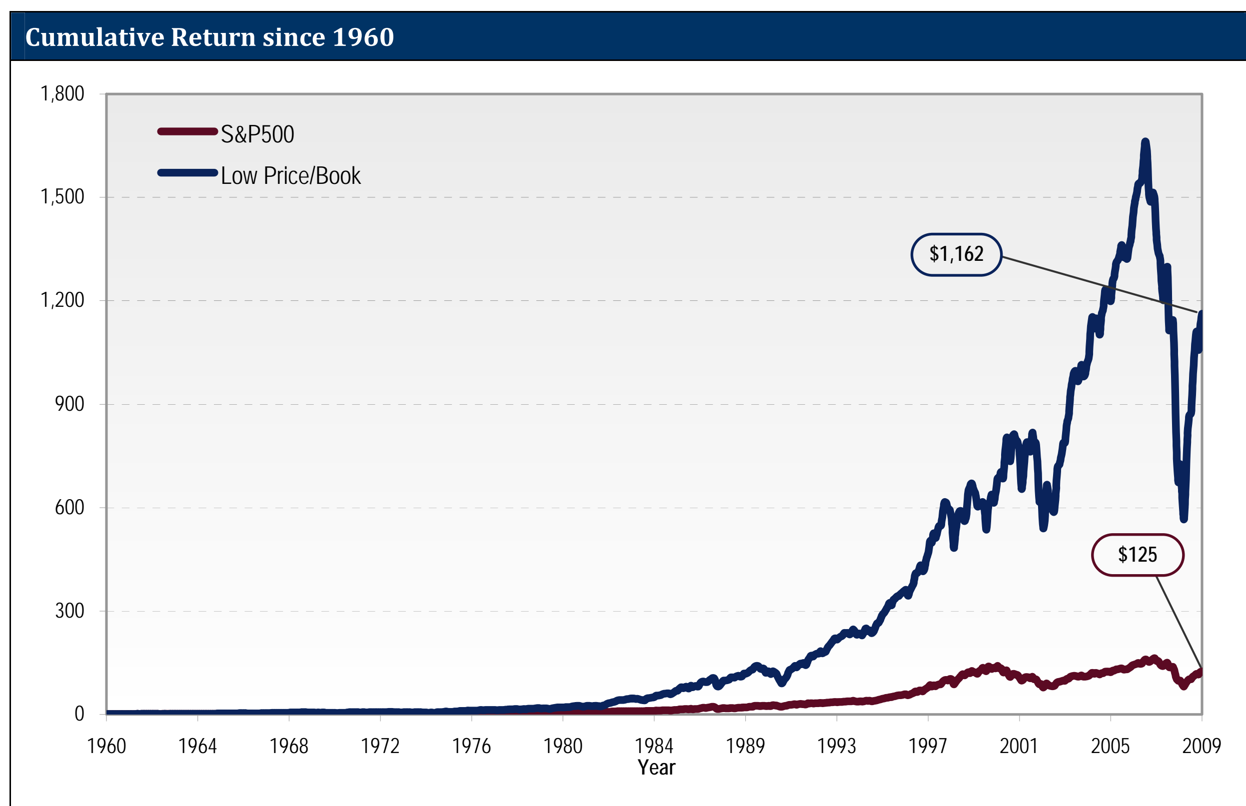
LOOKING FORWARD

The market today does not offer the same opportunity for returns as it did earlier in 2009, but 2009 was one of the best value investing environments of the last 50 years. Yet, the current environment in our estimation is still well above average in terms of value opportunities. We can see this on a very tangible level as we go stock by stock through our portfolio and compare what we own today to the stocks we have owned over the past fifteen years. We are also encouraged by the history of value cycles. When deep value stocks have had the kind of performance year we have seen in 2009 it typically has been the start of a multi-year period of outperformance for deep value strategies. So, we have reason to be optimistic about the near future, given our investment approach. Most importantly, though, we have 50 years of data that support our view that for any extended multi-year investment horizon one should always be optimistic about a deep value approach.

WHY ARE WE VALUE INVESTORS?

Charlie Munger, Vice Chairman of Berkshire Hathaway, has said, "all intelligent investing is value investing." When you look at the performance history of the Low P/B series, you understand why. We have performed a deep dive into 50 years of data on Low P/B stocks to understand the return attributes that a deep value approach to investing has produced. The data series takes the top 1,000 stocks ranked by price-to-book and creates an equal weighted portfolio of the bottom quintile with monthly rebalancing. The first thing that stands out when you look at this data is how superior the performance of the Low P/B series has been when compared to the S&P 500. Over 50 years, the Low P/B series has compounded at 15.2% per annum compared to 10.1% for the S&P 500. This 500bp advantage is magnified significantly by compounding over time. Thus a $1,000 investment in 1960 in the S&P 500 would leave you with $125,000 today. By comparison, that same $1,000 invested in the Low P/B series would leave you with over $1.1 million, almost ten times the amount you would have had from investing in the S&P 500.

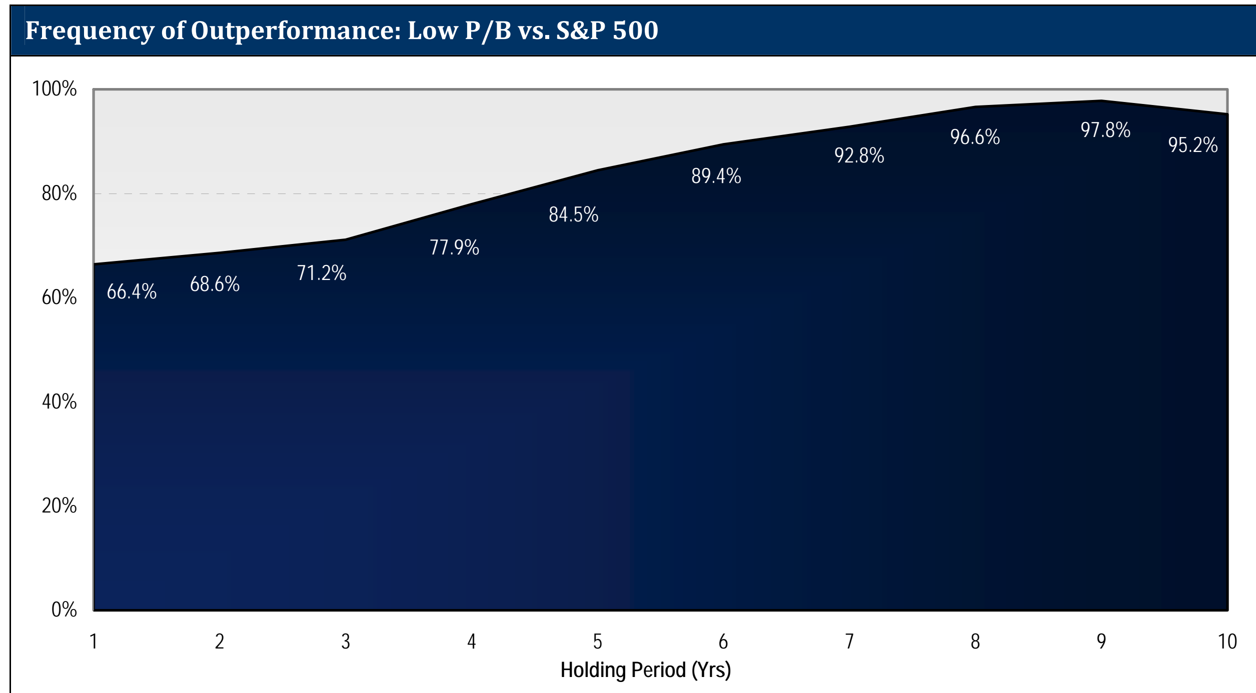
Cumulative Return since 1960



Source: Sanford Bernstein; Lyrical analytics

Not only has also has Low P/B outperformed the S&P 500 over the long term, but it also has outperformed during most periods of time. With a one year holding period, Low P/B has outperformed about two-thirds of the time. With a three year holding period, the outperformance rate improves to over 70%. With a five year holding period, the frequency improves to 85%, and at eight years or more you find Low P/B has outperformed 95% of the time or more.

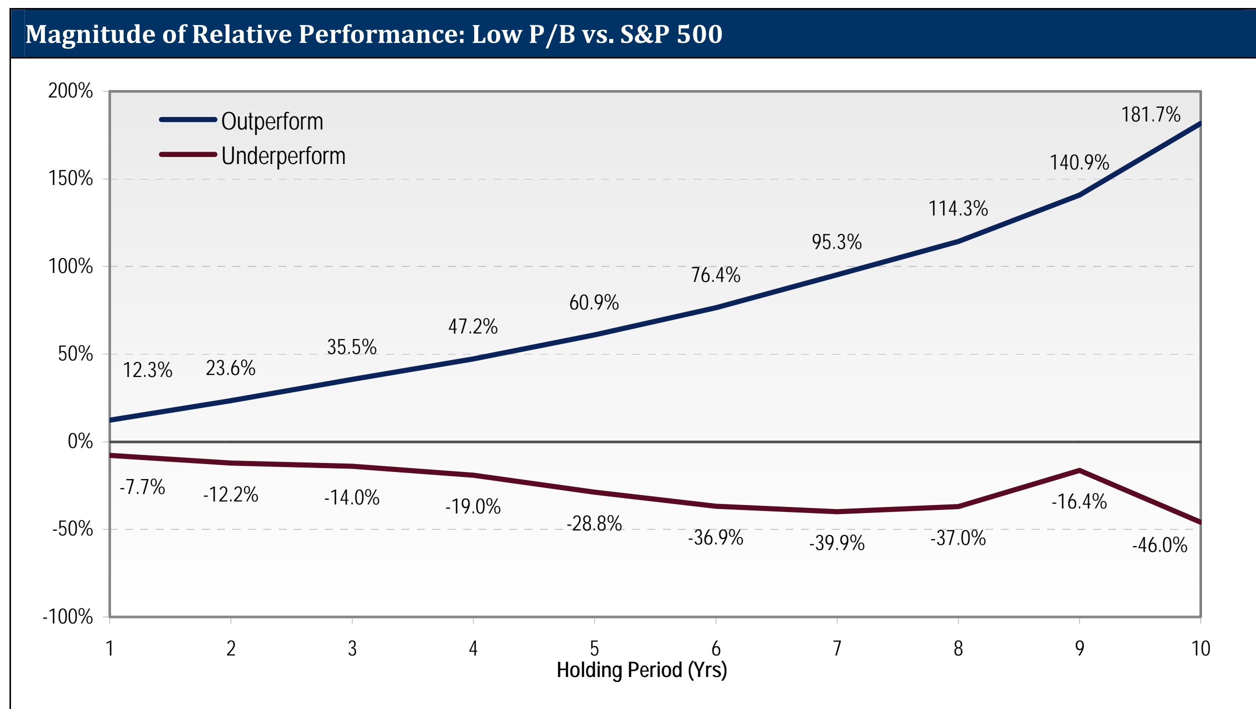
Frequency of Outperformance: Low P/B vs. S&P 500



Source: Sanford Bernstein; Lyrical analytics

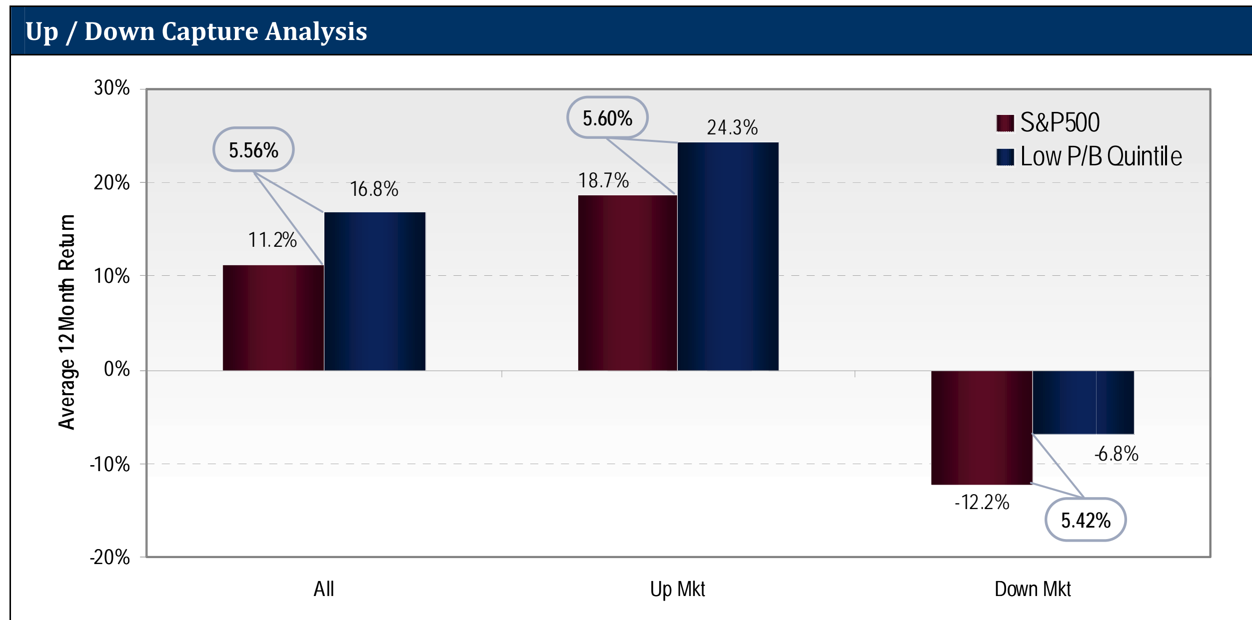
The Low P/B series also has had an advantage in the magnitude of returns relative to the S&P 500. In periods where Low P/B outperforms the magnitude of the relative return has been greater than the periods where Low P/B underperforms. In other words, Low P/B has won more when it wins than it has lost when it loses.

Magnitude of Relative Performance: Low P/B vs. S&P 500



Source: Sanford Bernstein; Lyrical analytics

Despite some common perceptions, the outperformance of value does not depend on bear or bull markets. In twelve month periods, whether the market has been up or down, the Low P/B series has performed almost equally well, outpacing the S&P 500 on average by over 500bps.

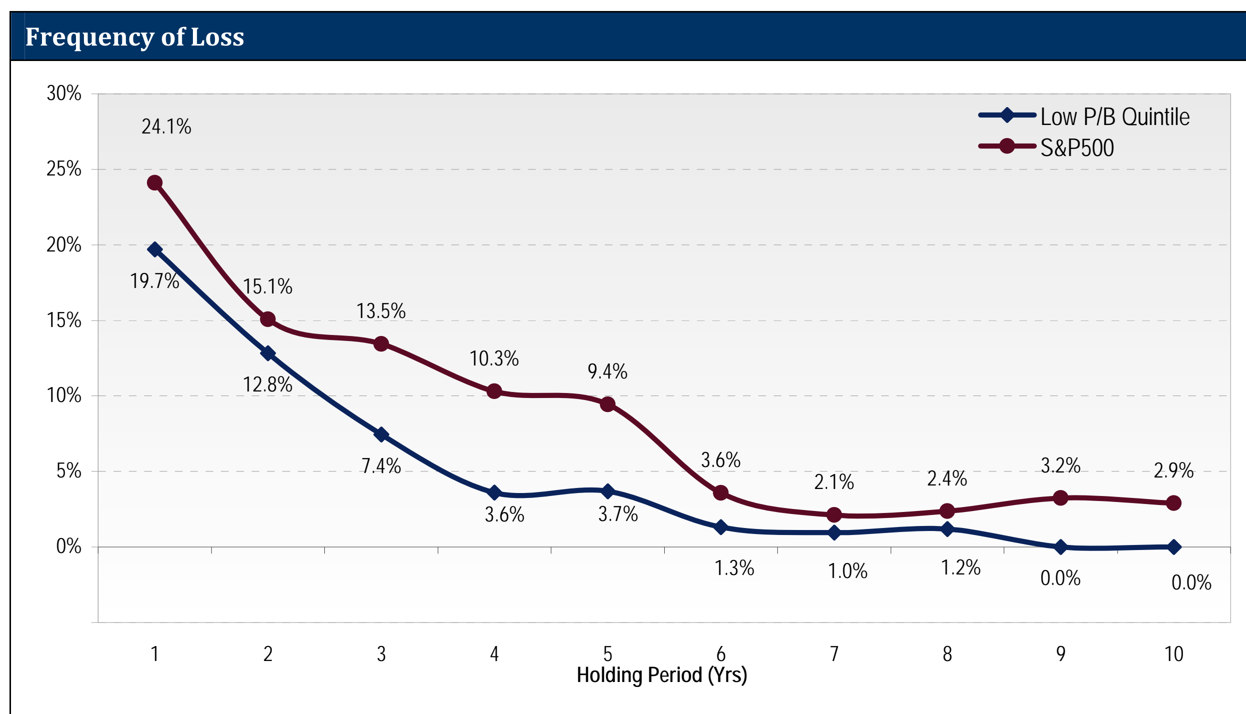


Source: Sanford Bernstein; Lyrical analytics

HOW CAN YOU BE LONG-ONLY AND ABSOLUTE RETURN DRIVEN?

Our approach in any and every market environment is always the same. We seek to own a balanced and diverse group of the best 30-40 stocks we can find. Over the short term, stock prices are volatile enough that we cannot be certain to generate positive results. Over longer periods, the growth in earnings and normalization of valuation take over and losses become increasingly rare. Once again we have analyzed the 50 year history of the Low P/B series to demonstrate the capital preservation superiority of a deep value approach. Specifically, we looked at different holding periods and calculated the frequency of loss (number of periods with a loss ÷ total number of periods). As expected, the longer the holding period the lower the likelihood of observing a loss of capital. Furthermore, the Low P/B series has shown a better ability to preserve capital as it has had a lower frequency of loss across all holding period lengths, including no observed losses for 9 or 10 year holding periods. What may be more interesting is that as holding periods get longer the frequency of loss has declined faster for Low P/B than for the S&P 500. This is because there has been stronger negative serial correlation for the Low P/B return series than for the S&P 500 (-10% vs. -1%, respectively). Put another way, time has been a better friend to the Low P/B series than to the S&P 500 series.

Frequency of Loss



Source: Sanford Bernstein; Lyrical analytics

HOME STRETCH

Given the overwhelming evidence, it is clear why we believe a deep value strategy is a highly effective approach to long term investing. At Lyrical Asset Management we use price-to-long term normalized earnings as our key value metric, not price-to-book. We also only invest in fundamentally good businesses, while the Low P/B universe includes many lower quality ones. However, our focus on deep value comes through, and our approach has had a 90-95% correlation to the Low P/B series. More importantly, as attractive as the returns for the Low P/B series have been, the returns for our approach have been even higher.

There have been extended periods where our funds or Low P/B have not delivered, but they have been few and far between, and so far have always been followed by periods of greater outperformance. As Damon Runyon said in one of my favorite quotes, "The race is not always to the swift, nor the battle to the strong, but that's the way to bet." When it comes to value investing, we at Lyrical Asset Management are all-in.

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.