2012 Review

At year-end, we celebrated our four year anniversary of managing capital for our clients. Over this period we have produced a total return nearly double the return of the S&P 500 Index, net of our fees. Our U.S. Value Equity composite four year gross return of 167.3% is in the top 1% among all Large Cap, Mid Cap and All Cap Value products in the eVestment Alliance database. (Note that eVestment uses gross performance for such rankings. To be clear, our net performance was 140.9% over that period). We are proud of our accomplishments and excited for our future. We thank our clients for their early and continuing confidence.

In 2012, our U.S. Value Equity composite portfolio generated a gross return of +19.2%, compared to +16.0% for the S&P 500 and +17.5% for the Russell 1000 Value.

	2009	2010	2011	2012	ITD
Lyrical Asset Management (Gross)	+80.2%	+25.0%	-0.5%	+19.2%	+167.3%
Lyrical Asset Management (Net)	+68.4%	+22.3%	-1.2%	+18.4%	+140.9%
S&P 500 (Total Return)	+26.5%	+15.1%	+2.1%	+16.0%	+72.4%
Relative Performance (Net)	+4,190 bp	+720 bp	-330 bp	+240 bp	+6,850 bp

Our outperformance this year was driven by our high batting average. Overall, 59% of the stocks in the portfolio outperformed the S&P 500. There was not much skew in the distribution of returns as our outperformers exceeded the S&P 500 by an average of 21%, while our underperformers lagged by an average of 24%.

Portfolio turnover in 2012 was 11.3%, compared to our average turnover of 16.6% per annum over the past four years. While portfolio turnover will fluctuate from year to year, we believe the average annual turnover of the past four years is representative for our disciplined value strategy. Nonetheless, we also believe it is unusual to experience such low turnover given the gains we have captured. Generally, such gains in a disciplined value strategy will produce higher turnover; however, the exceptionally low stock prices following the financial crisis explain why certain stocks could rise significantly and still be inexpensive relative to their earnings power. We believe the value opportunity in our portfolio is still very high in the context of our careers, although not quite as high as in early 2009 or even early 2012, two periods of exceptional dislocation in our estimation.

LOOKING BACK

In 2012, for the third year in a row it seems that the market was ruled by macroeconomic headlines. The fiscal situation in the US, Europe, and Japan indeed looks dire, and should be a significant headwind for economic growth for years to come. Earnings growth for the S&P 500 significantly decelerated this year to 5.0% from 15.7% last year, based on data from FactSet. However, in spite of this slowing growth, the S&P 500 produced a total return of 16.0%.

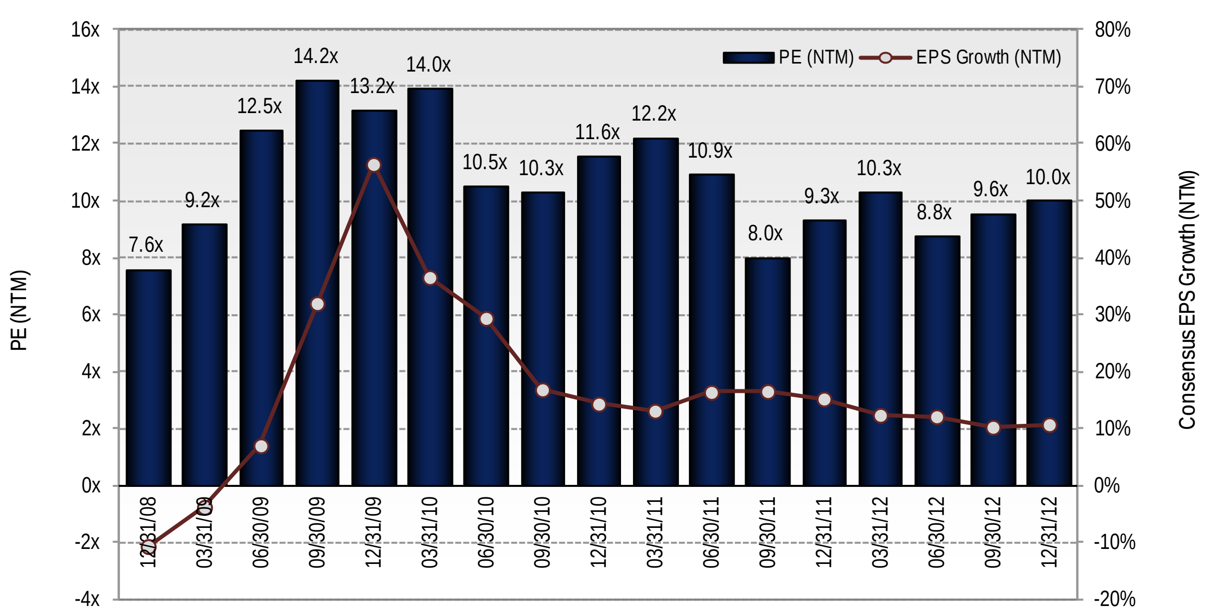
At first glance it seems irrational for the S&P 500 to be up so much when earning growth was so tepid, but when you look at the last twenty-four months, the bigger picture makes more sense. In 2011, the S&P 500 had strong earnings growth but little price appreciation, while 2012 price appreciation was greater than earnings growth. Over the last two years combined, the S&P 500 earnings expectations have increased by 21.5%, yet its price has appreciated by only 13.4%, compressing the multiple on forward EPS from 13.7x to 13.2x over the last two years. In our view, much of this year's appreciation should have occurred in 2011 but was deferred into 2012.

LOOKING FORWARD

Even after our strong absolute and relative returns this year, our portfolio remains attractively valued, both in absolute terms and relative to the S&P 500. The P/E ratio for our portfolio on forward consensus earnings estimates was 10.0x at the end 2012. While this is not as low a multiple as at the start of 2012, it still remains very attractive in comparison to the S&P 500, which at 13.2x is 32% higher, or to the 14.5x multiple on forward EPS that the S&P 500 has averaged over the past fifty years.

Furthermore, the consensus estimates for 2013 earnings growth for our portfolio is 9.2%, significantly higher than the 6.1% expected for the S&P 500. Given the lower multiple and higher expected growth, we are optimistic about our prospects for continuing to outperform the U.S. markets in the coming year.

Historical Portfolio Metrics



Source: FactSet; Lyrical analytics

TOP 1% AFTER FOUR YEARS

We used eVestment's database and examined the returns of all Large Cap, Mid Cap and All Cap Value products. While not all of these products are true peers of ours, we wanted to cast a wide net in capturing the performance data. In total, as of January 29, 2013 there are 599 products in those three categories that reported returns for each of the past four years. Lyrical Asset Management's U.S. Value Equity gross return of 167% ranks within the top 1% in that universe. *(Note again that eVestment uses gross performance for such rankings. Our net performance was 140.9% over that period).* Furthermore, even excluding our exceptional results from 2009, our trailing three years record is also noteworthy, ranking us in the top 10%.

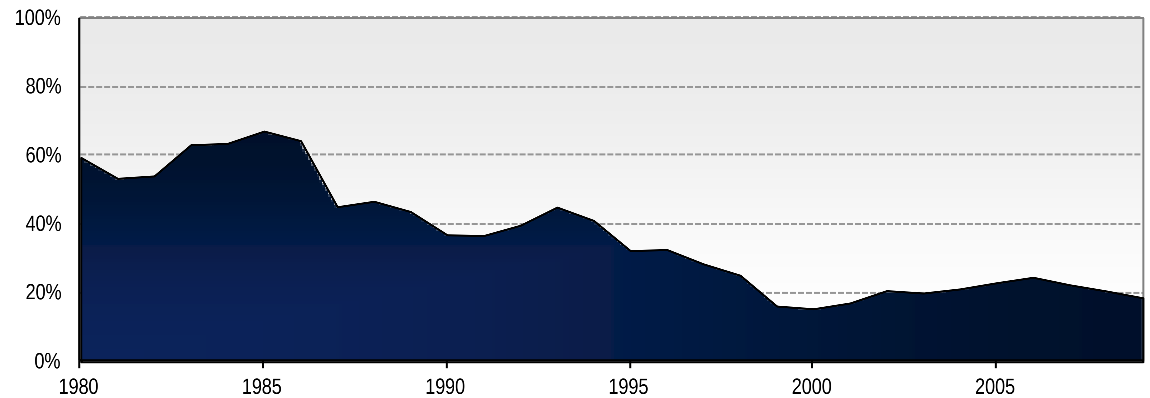
ACTIVE MANAGEMENT IS DEAD

On January 3, 2013 the Wall Street Journal published an article titled, "Investors Sour on Pro Stock Pickers." The opening sentence stated, "Investors are jumping out of mutual funds managed by professional stock pickers and shifting massive amounts of money into lower-cost funds that echo the broader market." Over the past two decades there has been a shift from active to passive funds, and that shift has accelerated since the financial crisis in 2008. According to the article, last year investors pulled $119.3B from actively managed U.S. stock funds, yet poured $30.4B into U.S. stock ETFs.

It is no wonder why investors are fleeing active management for low fee passive funds. Active managers, as a group, have underperformed their benchmarks net of fees by 41bp per annum over the last 20 years. This data is presented in the academic paper, "Active Share and Mutual Fund Performance," from December 2010 by Antti Petajisto from NYU Stern School of Business. This paper continues the work first presented in March 2009, in a paper Petajisto co-authored with Martijn Cremers titled, "How Active Is Your Fund Manager? A New Measure That Predicts Performance." In our 2010 Review letter, we highlighted this work and the metric it introduced called Active Share.

Active Share measures the percentage of a fund's portfolio that deviates from a benchmark. For example, an Active Share measure of 0% means the portfolio is an exact clone of a benchmark, while a measure of 100% means there is no overlap with the benchmark at all. Going back to 1980, the start of the study period, there was really no such thing as passive funds. Only 0.4% of assets were in funds with less than 20% active share. Closet Indexers didn't really exist either, with only 1.1% of assets in funds with active share between 20-60%. Highly active funds with active share over 80% held 60% of all mutual fund assets, with another 39% in moderately active funds with active share between 60-80%.

Share of Assets in Funds with >80% Active Share



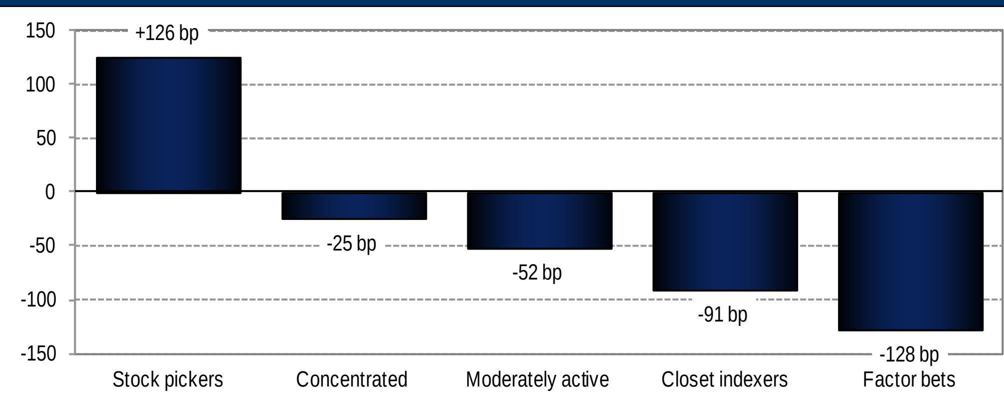
Source: "Active Share and Mutual Fund Performance," Antti Petajisto, December 15, 2010

By 2009, the mix of assets in mutual funds had shifted dramatically. Passive and closet index funds now account for over 50% of mutual fund assets. Another 31% is in moderately active funds. Highly active funds, which at the peak in 1985 held 67% of mutual fund assets, hold just 19% of assets now. What passes for active management today is no longer very active compared to the benchmarks.

...LONG LIVE ACTIVE MANAGEMENT

Therein lies the problem. Active management is failing not because pro stock pickers can't pick good stocks, but because many of the pros seem to have stopped trying. Managers collect fees, but they do not earn them. Petajisto in his 2010 paper uses active share and tracking error to put funds into five different categories. Closet indexers, funds with low active share and low tracking error, underperformed their benchmarks net of fees by 91bp per annum over the last 20 years. Factor bets, funds with high tracking error but moderate active share, were worse, underperforming by 128bp. Moderately active funds underperformed by 52bp. Only stock picker funds, those ranked in the top 20% by active share, outperformed. As a group they beat their benchmarks net of fees by 126bp over the 20 years. A fifth category, concentrated funds, with the highest tracking error and highest active share, underperformed but was not statistically significant.

Net Return for Five Types of Active Management (1990-2009)



Source: "Active Share and Mutual Fund Performance," Antti Petajisto, December 15, 2010

The data shows that active management works when it is truly active. We knew this from our experience long before Petajisto published his research. In our investment process we are blind to the benchmarks when we construct our portfolios, instead focusing on holding the 30-40 best stocks we can find in our universe. We are concerned about concentration risk, and have strict limits to manage such risk, but we have no concern for what the benchmarks hold. In an analysis done by institutional consultant Callan Associates, the active share of our portfolio relative to the Russell 1000 is 97%, placing us in the top 1% of all managers in their database. Active share that high is uncommon. In fact, half the products in the Callan universe have active share 76% or lower, and active share of 82% ranks in the top 10%. There are several key factors to our noteworthy historical success, and we believe our very high active share is certainly one of them.

CONCLUSION

We have been managing capital for our clients for four years, and we produced results superior to more than 99% of our peers. We have achieved this success with a disciplined, systematic, repeatable process. Furthermore, we achieve returns by investing, not trading. While the average mutual fund turns over their portfolio 80-90% in any given year, we have turned over ours just 66% over four years. Thus, we believe we offer an investment proposition that should endure for years and years to come.

Andrew Wellington,
Managing Partner
Chief Investment Officer

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.