

PARAMETRIC PERSPECTIVES

NEWSLETTER

/ ISSUE NO. 2

/ WINTER 2007

► Portfolio Turnover and Market Environment

by Tyson Alexander, CFA — Parametric Senior Portfolio Manager

Advisors concerned with custody and trading costs often ask us to estimate how much turnover we expect in a typical year. Passive investing in general has low turnover and is tax efficient. Our process is active in the sense that we will trade when the economic value we generate by harvesting tax losses exceeds the cost of trading. For a Tax-Managed Core portfolio, higher turnover means higher tax alpha.

It is difficult to predict what the turnover might be since each account we manage has unique tax circumstances and exists in a particular market environment. In this article we examine the experience of a few sample accounts to help set expectations.

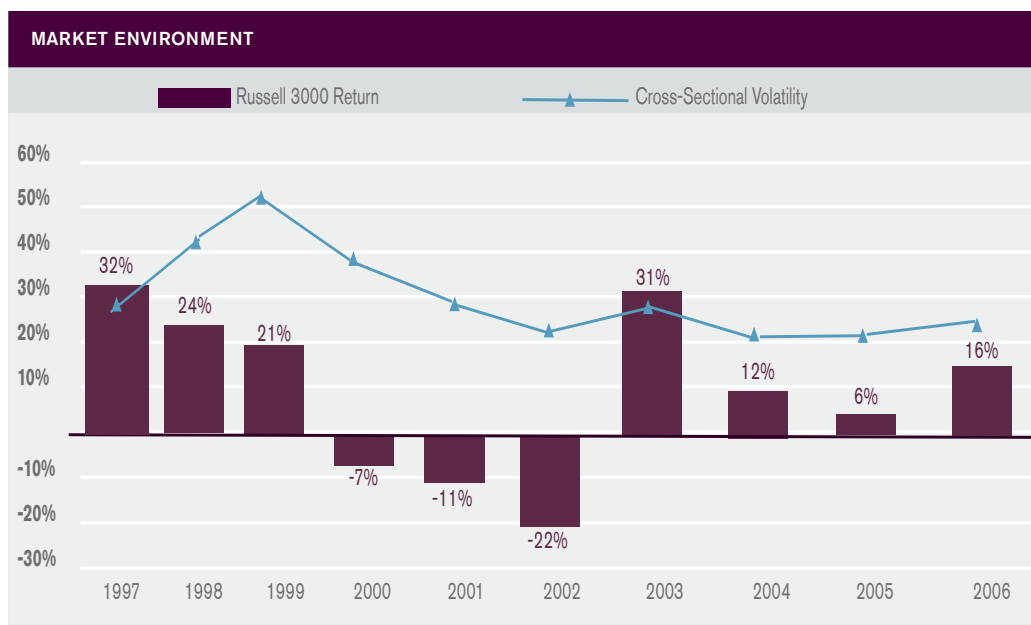
The following factors tend to reduce the amount of turnover in a specific client portfolio:

- Transferring low basis securities in-kind at inception
- Appreciation of the securities over time
- Raising cash from the portfolio by selling high basis securities (future turnover from loss harvesting reduced)

Market environment plays a key role as well. Below is a chart that shows the annual returns of the Russell 3000 Index versus cross-sectional volatility (defined as the standard deviation of individual stock returns within that year).

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Portfolio Turnover

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Bear markets, although never pleasant for investors, facilitate the task of loss harvesting. From 2000 to 2003 losses were abundant in most portfolios. However, bull markets can also be good for loss harvesting, if volatility is high. For example, 1999 was a great year for loss harvesting despite the overall market return of +21% because of the high cross-sectional volatility. In other words, though the market was positive as a whole, many stocks had negative returns and thus made tax losses available for harvesting. In contrast, 2003 had high returns with very few stocks posting negative returns. This provided investors with some relief from the bear market, but made the job of harvesting losses more challenging.

To help understand how turnover might be experienced in a portfolio, eight client portfolios benchmarked to the Russell 3000 were selected with few cash flows or restrictions.

Each sample account was funded with cash in a different year from 1998 to 2005. The table below shows annual turnover and tax alpha. Turnover is defined as the total market value of

TAX LOSS HARVESTING ENVIRONMENTS

	BULL MARKET	BEAR MARKET
High Cross-Sectional Volatility	Favorable (1999)	Favorable (2001)
Low Cross-Sectional Volatility	Challenging (2003)	Favorable (2002)

securities sold during a period divided by the portfolio market value in that period. Tax alpha is the difference between the portfolio's pre-tax performance versus the benchmark and the after-tax performance versus the benchmark, or put simply it is the value added through tax management of the portfolio.

The oldest portfolio, incepted in 1998, had an 89% turnover in the first year, realizing a significant amount of tax losses, providing 7.6% after-tax alpha and a high total return—the best of both worlds. In contrast the portfolio that was incepted in 2003 had a 5% turnover that year and realized fewer tax losses. Notice that each portfolio invested in 2003 had a low turnover in that year (looking diagonally in the table). Low tax alpha in this year, but the good news is that the portfolios were up 30% in that year with low

transaction costs.

In summary, we see that in the first year the turnover ranged from 5% to 89%, but tends to decline over time as the portfolios mature. In the last column the average annual turnover for each account is calculated over its lifespan.

While stating that we expect turnover of 15% to 20% per year over the first five years of a tax-managed core portfolio may be accurate, any one client's actual experience will also depend on the market environment and the loss harvesting potential in their portfolio.



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SAMPLE PORTFOLIOS BENCHMARKED TO THE RUSSELL 3000 1998-2005

	PORTFOLIO 1	PORTFOLIO 2	PORTFOLIO 3	PORTFOLIO 4	PORTFOLIO 5	PORTFOLIO 6	PORTFOLIO 7	PORTFOLIO 8	AVERAGE
INCEPTION DATE	6/22/1998	5/19/1999	6/15/2000	7/5/2001	4/18/2002	7/23/2003	5/14/2004	6/1/2005	
Year 1 Turnover	88.6%	63.2%	55.0%	24.9%	16.5%	5.4%	29.3%	23.6%	
Year 2 Turnover	40.7	29.3	14.6	24.2	10.3	21.2	10.0		
Year 3 Turnover	21.4	59.6	19.4	6.7	10.6	5.4			
Year 4 Turnover	18.5	24.8	9.7	15.5	7.8				
Year 5 Turnover	32.5	4.0	11.2	6.9					
Year 6 Turnover	3.3	7.8	10.6						
Year 7 Turnover	4.1	7.4							
Year 8 Turnover	7.8								
Average Annual Turnover per Portfolio	27.1%	28.0%	20.1%	15.6%	11.3%	10.7%	19.6%	23.6%	19.5%
Average Annual Tax Alpha per Portfolio	2.1%	1.4%	2.6%	1.9%	1.7%	0.7%	1.2%	1.3%	1.6%

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► Market Commentary

by Tom Seto, Director of Portfolio Management

During the fourth quarter, the inflation-minded Federal Reserve appeared content that the economy was neither too hot nor too cold and left interest rates alone for the third and fourth time in a row. Investors seemed to agree with this "Goldilocks" notion that the economy was just right, as US equities had their best quarter of the year, the S&P 500 Index up 6.7%.

Once again sector rotation reigned, as the third quarter's worst performing economic sectors, materials and energy, were the fourth quarter's best performers, both up over 11%, while health care, a top performing sector in the third quarter, was the worst performer in the fourth quarter, up just 1.4%. Value outperformed growth, as investors gravitated towards cheaper stocks, those with lower prices relative to their trailing earnings and book values (S&P 500/Citigroup Value Index, +7.7%; S&P 500/Citigroup Growth Index, +5.6%). Size was not a factor in driving returns in the last quarter of 2006, as mid-cap and small-cap stocks performed similarly to large-cap stocks (S&P MidCap 400 Index, +7.0%; S&P SmallCap 600 Index, +7.8%).

While the economic environment seemed ideal in the fourth quarter, with low interest rates, low inflation and solid GDP growth, the political environment was more turbulent, the US electorate giving both houses of Congress and the majority of governorships to the Democrats for the first time in 12 years. Although largely motivated by the war in Iraq, this major political shift could increase volatility in the stock market. In this environment, our broadly diversified, sector-neutral Tax Managed Core portfolios will provide a great opportunity to capture the next market leaders, while doing so in a tax efficient manner.

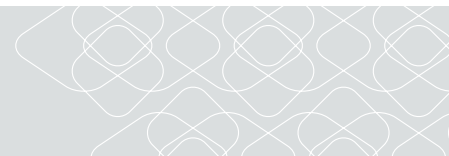


Tom Seto is the Director of Portfolio Management at Parametric and is responsible for all portfolio management strategies.

INDEX PERFORMANCE AS OF DECEMBER 31, 2006

INDEX	Q4 2006 %	YTD %	YTD %
Broad Market			
Russell 3000	7.1	15.7	15.7
S&P 1500	6.8	15.3	15.3
Mega Cap			
S&P 100	6.5	15.9	15.9
Russell Top 200	6.7	15.5	15.5
Large Cap			
Russell 1000	7.0	15.5	15.5
S&P 500	6.7	15.8	15.8
Domini Social 400 ¹	6.3	13.2	13.2
Large Cap Fundamental			
FTSE RAFI 1000	6.7	17.1	17.1
WisdomTree LC Dividend	6.5	20.0	20.0
WisdomTree High Yield Equity	6.3	22.6	22.6
Large Growth			
Russell 1000 Growth	5.9	9.1	9.1
S&P 500/Citigroup Growth	5.6	11.0	11.0
Large Value			
Russell 1000 Value	8.0	22.2	22.2
S&P 500/Citigroup Value	7.7	20.8	20.8
Mid Cap			
Russell Midcap	7.7	15.3	15.3
S&P MidCap 400	7.0	10.3	10.3
Small Cap			
Russell 2000	8.9	18.4	18.4
S&P SmallCap 600	7.8	15.1	15.1
Small Cap Value			
Russell 2000 Value	9.0	23.5	23.5
S&P 600/Citigroup Value	8.4	19.6	19.6
Small Cap Growth			
Russell 2000 Growth	8.8	13.4	13.4
S&P 600/Citigroup Growth	7.3	10.5	10.5
International			
MSCI EAFE	10.4	26.3	26.3
MSCI World	8.4	20.1	20.1
International Fundamental			
FTSE RAFI Developed Ex-US	10.6	25.8	25.8
WisdomTree DIEFA	12.2	34.0	34.0
Emerging Markets			
S&P/IFCI Emerging	18.8	30.2	30.2

Source: Russell, S&P, MSCI, KLD, FTSE, Factset, Bloomberg, WisdomTree. We believe the information provided here is reliable but do not warrant its accuracy or completeness.



Parametric™

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About Parametric

Parametric is the industry-leading provider of structured portfolio management. Headquartered in Seattle, Washington, Parametric offers a variety of structured portfolio solutions, including customized core equity portfolios (US, Non-US, Global Tax-Managed Core™), and overlay portfolio management (OverlayOne™).

Total AUM: (12/31/06)

\$19.2 Billion

Established:

1987

WHAT'S NEW?

Parametric licenses broad set of fundamental indices

Parametric has now licensed a variety of fundamentally weighted indices from FTSE and WisdomTree. Both families of indices cover US and non-US stocks.

"Tax-managed accounts that track these indices are ideal for investors that favor a value-based approach to investing and also want a tax-efficient indexed portfolio," said Paul Bouchey, Senior Research Manager for Parametric's Tax-Managed Core strategy.

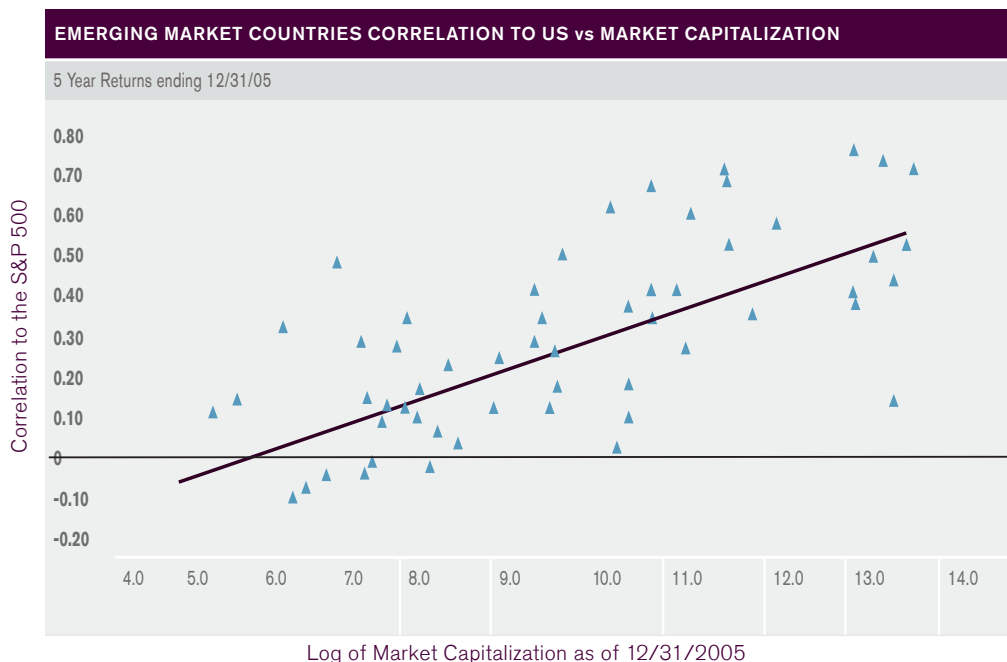
The indices in the FTSE RAFI Index Series[®] are weighted using four fundamental factors, rather than market capitalization. These factors include dividends, cash flow, sales, and book value.

The WisdomTree Indexes[®] are dividend weighted—the index is weighted according to the proportionate share of the aggregate cash dividends each company is projected to pay in the coming year, based on the most recently declared dividend per share.

Below is a list of fundamentally weighted indices that can now be targeted with a Parametric Tax-Managed Core account:

- FTSE RAFI 1000 Index
- FTSE RAFI US Mid Small 1500 Index
- FTSE RAFI Developed Ex-US Index
- WisdomTree Dividend Index
- WisdomTree LargeCap Dividend Index
- WisdomTree High Yielding Equity Index
- WisdomTree DIEFA Index
- WisdomTree International LargeCap Index
- WisdomTree DIEFA High Yielding Equity Index

► Data Corner: Large Emerging Market Countries Have High Correlations



Correlation of S&P/IFC emerging market country returns to the S&P 500 Index for 5 years ending 12/2005 by the logarithm of market capitalization.

The correlation of the larger emerging markets to S&P 500 has increased over the last 10 years, while smaller markets still tend to be driven by local issues. The diversification benefit this provides is one of the reasons Parametric's emerging market strategy emphasizes many smaller emerging markets not found in the major indices or the typical core emerging market strategies.