Parametric™
Leaders in Structured Portfolio Management

PERFORMANCE COMMENTARY:

Q2 2009 TAX MANAGED LARGE CAP CORE COMPOSITE

Research Brief
Summer 2009

In the second quarter of 2009, the pre-tax return of the TMC Large Cap Composite was 15.20%, lagging the S&P 500 return of 15.94% by 74 basis points. While this is within our expected tracking error guidelines for most accounts, we thought it would be useful to share some analysis of the sources of these returns. In general, there is a tendency for loss harvesting portfolios to outperform in momentum markets (2008 is a good example) and underperform in reversal markets (like April 2009). ▸▸

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Specifically, we can attribute the excess return in Q2 2009 to three primary sources:

- security selection effect within the financial sector (-35bps),
- selection effect in the consumer discretionary sector (-13bps), and
- cash drag (-9bps).

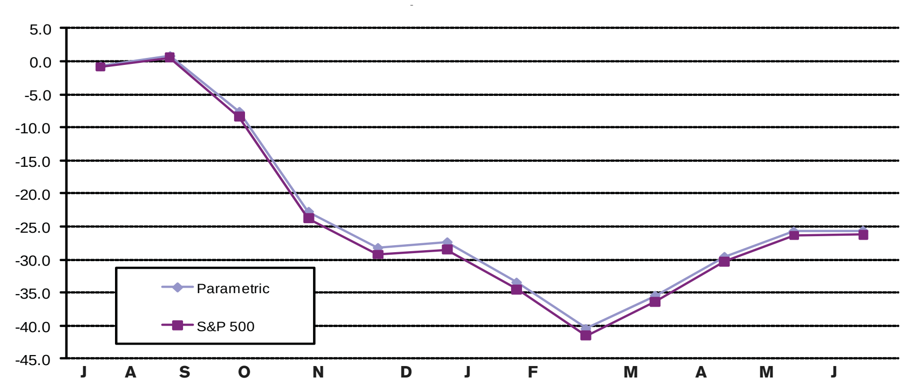
We also observed that most of the return differences occurred in April, with systematic biases to risk factors contributing -29bps to the excess return in that month. We are confident that our portfolios are tracking the index within guidelines—over a trailing twelve month period, the composite is +60 basis points relative to the index, with the recent underperformance more than offset by outperformance during the down market.

PERFORMANCE

The U.S. equity market showed a phenomenal 16% return in the second quarter of 2009. The upward trend was a continuation of the market recovery that began in early March. While the sharp recovery is positive for markets, it poses specific challenges for tax-managed portfolios. In the months leading up to the market recovery, the downward market trend provided ample opportunities for loss harvesting. The after tax alpha for tax managed portfolios in 2008 was between 3% and 5%. Loss harvesting causes certain names to be held at a slight underweight. The slight underweight enables us to achieve our dual goals of tracking the benchmark and harvesting losses. In strong momentum markets (where the market shows a distinct direction) the tax managed portfolio is expected to slightly outperform. This was seen during the down market of 2008 where the composite outperformed the benchmark by 1.49%. Following a consistent down market, a sharp reversal in the market can cause underweighted names to result in a slight underperformance, as seen in Q2 of this year. Over time these effects are expected to offset each other resulting in a long term performance in line with the 1% annual tracking error limit used to manage most portfolios.

As a response to the increased volatility in the market, Parametric has taken steps to reduce the relative risk level of client portfolios. Bias tolerances to risk factors and individual securities have been reduced. We believe that this effort has been effective in controlling the tracking error of the portfolios we manage. The trailing 12 month return of the composite was -25.58% versus -26.20% for the S&P500. The excess return of +60bps over the trailing 12 months is consistent with the tracking error limit of 1% targeted for most accounts.

Figure 1:
TRAILING 12 MONTHS CUMULATIVE RETURN COMPOSITE VS. S&P 500



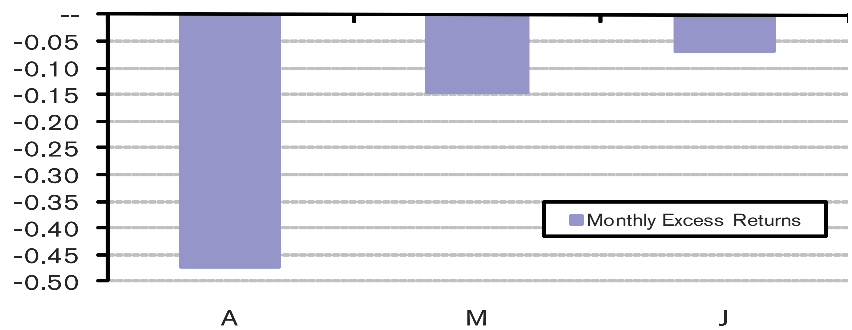
This composite represents the average of Parametric Large Cap Core based accounts. Individual account performance may vary.

ATTRIBUTION FOR Q2 2009

Financials

The chart below shows the excess return of the composite for each month in Q2 2009:

Figure 2:
MONTHLY EXCESS RETURNS OF THE TMC LARGE CAP CORE COMPOSITE FOR Q2 2009



While the total excess return for the quarter was -74bps, the majority of the negative return occurred in April. During this month the composite underperformed the benchmark by -47bps. During the months of March and April, the S&P500 showed large positive returns; 8.76% and 9.57% respectively. The month of March marked the beginning of the sharp recovery of the S&P500. As previously mentioned, the tax management process has the potential to underperform during a sharp market recovery. When loss harvesting portfolios, names that show losses are sold and held at an underweight. In some cases, these names can recover quickly causing the portfolio to underperform. During the month of April this was the case for many names in the financial sector (ie. Citigroup, Wells Fargo, American Express). The Dow Jones U.S. Financial Index ETF (Ticker: IYF) was up over 20% in March and 16% in April. Subsequently, when the sector recovered quickly in April, the composite lagged the benchmark.

Consumer Discretionary

Over the period, security selection effects in the consumer discretionary sector contributed -13bps to the excess return. Similar to the financial sector, the consumer discretionary sector showed a strong reversal starting in March. The Consumer Discretionary SPDR ETF (Ticker: XLY) was up 12% in March followed by 18% in April. The largest single contributor in this group was Ford Motor Co. Ford was held at an underweight in many portfolios. During the month of April, Ford stock rose by over 120%. Being underweight Ford contributed -6bps to the excess return over the period.

Cash

For Parametric's TMC Large Cap Core composite, the average weight of cash was +56bps during Q2 2009. Since the S&P 500 returned 15.94% over the period, cash drag accounted for -9bps of the excess return.

Factors – Excess Return in April

Returns due to systematic factor biases contributed -29 bps to excess return during the month of April. The Volatility and Momentum factor returns in the Barra risk model were large compared to typical levels. A negative volatility bias of -1.69 and a positive momentum bias of 2.23 coupled with large factor returns resulted in underperformance of -29 bps. The pattern of the large negative momentum return and large volatility return is typical within months of sharp market reversal. Earlier this year, Parametric took steps to mitigate the negative effects of the market reversal on client portfolios by reducing the risk factor bias tolerance used to manage portfolios.

Figure 3:

BIAS TO THE BARRA MOMENTUM AND VOLATILITY FACTORS AND THE FACTOR RETURNS

	VOLATILITY			MOMENTUM			
	Bias	Return	Cont. (bps)	Bias	Return	Cont. (bps)	Total
April	-1.69	6.2%	-11	2.23	-8.2%	-18	-29
May	0.59	1.0%	1	0.63	-3.3%	-2	-1
June	-0.13	-1.9%	0	0.73	-1.3%	-1	-1

CONCLUSION

Parametric's TMC Large Cap Core Composite showed an excess return of -74bps compared to the S&P 500 index for Q2 of 2009. Excess returns arose predominantly from three sources over the period:

- Security selection effects in the financial sector as a result of loss harvesting
- Security selection effects in the consumer discretionary sector
- Cash bias caused -9bps over the period

From a risk factor perspective, we saw biases to the momentum and volatility factors resulted in -29bps of underperformance in the month of April.

The trailing twelve month excess return of +60bps is in line with the tracking error limit used to manage most portfolios.

About Parametric

Parametric is an industry-leading provider of structured portfolio management, headquartered in Seattle, Washington. Parametric and its affiliate, Parametric Risk Advisors, offer a variety of structured portfolio solutions, including customized core equity portfolios (U.S., Non-U.S., global Tax-Managed Core™), options strategies (DeltaShift℠), emerging markets (Structured Emerging Markets™), and overlay portfolio management (OverlayOne™).

Note: This information is for illustrative purposes only and should not be considered investment advice or recommendation to buy or sell any particular security. Parametric does not provide tax advice. It is not possible to directly invest in an Index. Past performance does not predict future results.

Disclosures

This information should not be considered investment advice or a recommendation to buy or sell any particular security. The information in this material and specific securities mentioned are not representative of all securities purchased, sold or recommended for advisory clients. Actual portfolio holdings will vary for each client and there is no guarantee that a particular client's account will hold any, or all, of the securities identified. It should not be assumed that any of the securities or recommendations made in the future will be profitable or will equal the performance of the listed securities. It is not possible to invest directly in an Index. Past performance does not predict future results.

Composite Criteria

All reported composites include only accounts funded with cash and free from client-directed investment restrictions. Because Parametric manages each account to reflect client specific characteristics, accounts funded with securities and/or subject to restrictions will experience varying performance.

Tax-Managed Core — Benchmark: S&P 500. Accounts managed in the Parametric Tax Managed investment style that seek large capitalization U.S. equity exposure and are benchmarked against the S&P 500 index.

Account Criteria

All accounts included in each composite are fully discretionary. There is no minimum balance requirement for an account to be included in a composite. Accounts are included in their respective composites in their first full month of management. Accounts are excluded from their respective composites after their last full month of management. Terminated accounts are included in their respective composites for all full periods prior to termination.

Calculation Methodology

Account Level – Account performance is calculated using a time-weighted, daily-linked total return methodology. Dividend and interest income is accounted for on an accrual basis. Performance labeled "Net of Fees" reflects the deduction of a 0.45% annual management fee – the highest fee paid by any account in this composite.

Composite Level – Composite returns are market-value weighted using beginning period values.

After-Tax Performance

After-tax performance calculations are based upon Parametric's best information concerning dividend and capital gain realization. Parametric's calculations incorporate highest U.S. Federal marginal tax rates only - unless directed otherwise by client or financial advisor. Individual investor after-tax experience will vary according to each investor's unique tax circumstances. As with all after-tax performance, the after-tax performance reported is an estimate. In particular, it has been assumed that the investor has, or will have sufficient capital gains from sources outside of this portfolio to fully offset any net capital losses realized, and any resulting tax benefit has been included in Parametric's computation of after-tax performance.

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