

PARAMETRIC PERSPECTIVES

NEWSLETTER

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NEWSLETTER HIGHLIGHTS

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► Diversification + Rebalancing: Structured Active Portfolio Management

Parametric recognizes the efficiency of markets. Most markets are 'sufficiently efficient', meaning that over time and after factoring all investment costs, the markets are hard to beat (see the accompanying SPIVA article). One reason for this is that cap-weighted indexes require little rebalancing. If there are no dividends, corporate actions, IPOs, or changing constituents, a capitalization-weighted portfolio stays cap-weighted without any trading — a significant cost advantage.

Parametric's Structured Tracking product suite, which includes the Tax-Managed Core and Custom Index offerings, is built upon the notion that cap-weighted, buy-and-hold portfolios are difficult to beat over time. However, cap-weighting is not a perfect solution. A cap-weighted portfolio has a tendency to become concentrated; the higher the volatility of the assets, the more likely this is to occur. Notable examples include:

- Japanese stocks in the 1980s grew from 10% up to 35% of world market cap by 1989, then over the next decade fell in weight back to 10%
- Technology stocks in the late 1990s grew from 10% to 25% of world market cap by 1999, then collapsed over the next two years back to 10%

Many asset classes are defined by arbitrary index construction methodologies and suffer from heavy concentrations in a small number of securities. This adds to short-term risk and compromises long-term growth. In these instances, one can expect to reduce risk by increasing diversification. This is especially true in the case of emerging markets, commodities, and currencies, which are all marked by high volatility and low correlations. Many researchers have also observed that, in these asset classes, a simple portfolio structure that is periodically rebalanced to equal-weights will add significant value versus cap weighting. This activity is referred to as 'volatility pumping' or 'volatility harvesting'.

To capture this value, Parametric developed a Structured Active investment approach. Structured Active offerings are more broadly diversified than their representative benchmarks and are further defined by a systematic rebalancing function that keeps concentrations from building over time. These strategies follow disciplined, rules-based investment guidelines and do not rely on explicit forecasts of expected returns.

The first product offering in this discipline was our Structured Emerging Markets strategy (SEM), which launched in 1994. Today, SEM has almost \$11bb in AUM, and has historically provided better risk-adjusted returns than applicable emerging markets indexes.

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We have followed on the success of SEM by developing several other equity products, as well as specialty asset class categories. Each strategy reflects the unique attributes of its target asset class while incorporating our central tenets of:

- Enforced Diversification
- Reduced Volatility
- Systematic Rebalancing
- Careful Trading and Implementation

Structured Emerging Markets	Countries are sorted into liquidity tiers and equally weighted within each tier. Countries are rebalanced when the weights drift outside of specified bounds. Within each country, sectors are diversified. Within sectors, stocks are cap-weighted subject to liquidity constraints.
Structured Commodity	Commodities are sorted into liquidity tiers and equally weighted within each tier. Commodities are rebalanced during the roll period, and intra-month when weights drift outside of specified bounds. Futures are rolled from 2nd to 3rd contract. Fully collateralized.
Structured Currency	Developed and Emerging Market currencies (except USD) are equally weighted and rebalanced during the roll period and when weights drift outside of specified bounds. Currency forwards are used to gain exposure and are fully collateralized.
Structured US, International, Global	These portfolios use the Russell 3000 [®] , MSCI EAFE, and MSCI ACWI indexes, respectively, as their starting universe. Here we employ a risk model and optimization process to minimize variance, subject to diversity constraints.

► Scorecard: S&P's SPIVA[®] – Active vs. Index Analysis

Since 1992, Parametric has advocated that, particularly for taxable investors, index-based investing can create powerful results. A Parametric Tax-Managed Core portfolio combines the consistency, transparency, and inherent low turnover of cap-weighted indexing with extensive customization – most notably active tax-management. The performance thesis for TMC is straightforward: (1) traditional index strategies are very competitive relative to the pre-tax universe of active strategies and, (2) If TMC can outperform a traditional index on an after-tax basis, it is likely to be difficult to beat.

Solid support for the pre-tax competitiveness of index-based investing comes from the Standard & Poor's Indices Versus Active (SPIVA) U.S. Funds Scorecard, which were recently released for the five years ended December 2010. The SPIVA Scorecard is unique because it provides performance comparisons corrected for survivorship bias, shows equal and asset-weighted results, and measures managers' style consistency.

At the end of the 2010 calendar year, nearly all major categories of active domestic funds lagged their benchmarks over one, three, and five-year periods. This trend held whether manager returns were measured with equal weighting or asset weighting. In the few cases where active manager performance beat the index performance, the margin of outperformance was minimal.

Percentage of Funds Outperformed by Benchmarks:

FUND CATEGORY	COMPARISON INDEX	ONE YEAR	THREE YEAR	FIVE YEAR
All Large Cap Funds	S&P 500	65.7	57.7	61.8
All Mid Cap Funds	S&P MidCap 400	73.8	83.9	78.2
All Small Cap Funds	S&P SmallCap 600	53.4	70.1	63.0
All Multi Cap Funds	S&P Composite 1500	63.9	60.8	66.3

Asset Weighted Fund Performance:

CATEGORY	ONE YEAR (%)	THREE YEAR ANNUALIZED (%)	FIVE YEAR ANNUALIZED (%)
S&P 500	15.1	-2.9	2.3
All LargeCap Funds	13.6	-2.9	2.2
S&P MidCap 400	26.6	3.5	5.7
All MidCap Funds	23.1	0.9	5.0
S&P SmallCap 600	26.3	3.0	4.7
All SmallCap Funds	25.9	2.4	4.7
S&P Composite 1500	16.4	-2.2	2.7
All MultiCap Funds	15.9	-1.8	3.1

Source: Standard & Poor's, CRSP. For periods ending December 31, 2010. Charts and graphs are provided for illustrative purposes only. Indices are statistical composites and their returns do not include payment of any sales charges or fees an investor would pay to purchase the securities they represent. Such costs would lower performance. It is not possible to invest directly in an index. Past performance is no indication of future results.

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► Investing in Commodities: Taking on the Challenges

by Timothy Atwill, Ph.D., CFA, FCAS

In recent years, the commodity asset class has received increasing attention due to its inflation-fighting properties, its low correlation with other asset classes, and its equity-like returns. When talking about commodities, investors are typically referring to a portfolio of commodity futures, fully backed by cash collateral. However, indexes for commodity futures do not have a naturally unbiased weighting scheme similar to market capitalization in equities. Index providers have come up with different arbitrary weighting schemes to replace market cap. This has led to three major commodity indices presenting surprisingly different risk/return profiles for three supposed representations of commodity beta:

RISK & RETURN (JANUARY 2000 - DECEMBER 2010)

	S&P GSCI®	DJ-UBSCI SM	RICI®
Return (p.a.)	5.4%	8.0%	10.8%
Volatility (ann.)	25.1%	17.5%	19.5%
Sharpe Ratio	0.11	0.31	0.42

Source: Bloomberg

The takeaway is that commodity indexes do not represent an unbiased “slice of the market”, but are simply very explicit portfolio trading strategies.

Perils of Passive Exposure

Passive solutions in equities are sought due to their low cost and unbiased nature. Accordingly, many investors look to passive solutions when they invest in the commodity asset class. However, key differences remain:

- 1) Passive products are based on “broken” benchmarks, which tend to have concentration issues, as seen below for the GSCI and DJUBS:

SECTOR WEIGHTS (AS OF DECEMBER 2010)

	S&P GSCI®	DJ-UBSCI SM
Energy	69.8%	33.0%
Base Metals	8.4%	17.8%
Precious Metals	3.2%	13.7%
Ags/Live Stock/Other	18.7%	35.4%

Source: Goldman Sachs, Dow Jones Indices, RICI® Handbook, 2010 version

- 2) Indexes underlying the passive exposure are very explicit about their trading rules for rolling futures exposure. This has led to front-running by more active traders to the detriment of passive investors.

Aggravations of Active Strategies

Passive perils may suggest that active investment approaches would be the better way to access this category, but these also have their own set of challenges. Most active commodity strategies are problematic because, in many ways, they can unwind the motivation for entering the asset class in the first place.

- 1) Actively managing the commodity futures positions can result in a manager being flat or short a commodity, which can undercut its inflation-fighting potential.
- 2) Actively managing the collateral uses similar active bets as those present in mainstream fixed-income portfolios. This not only increases correlation with the fixed-income portion of an investor’s portfolio, but the increased duration can be negative during inflationary times.
- 3) “Active Indexes” have been developed, which promise to outperform by using smart filters and algorithms. Unfortunately, it is hard to judge the forward-looking performance and diversification properties of these strategies. In addition, if any of these advisors did gain sufficient AUM, they would be open to front-running.

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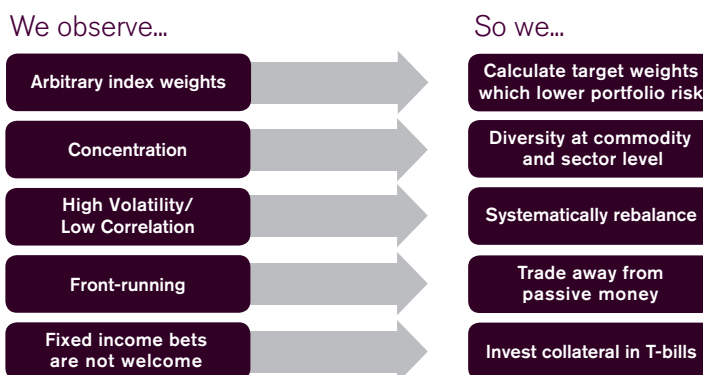
These results show that index-based strategies offer a competitive and often times superior alternative to active strategies, which are typically accompanied by higher fees and greater dispersion of returns. This can be especially true for taxable investors, who face the additional hurdle of taxation of all capital gains. Parametric is currently working with S&P® to analyze the SPIVA U.S. equity scorecard on an after-tax basis.

For taxable individuals, a Parametric Tax-Managed Core portfolio can be an even more compelling choice to other index alternatives, as after-tax returns are enhanced by the strategies of realization of capital losses, gain deferral, tax-efficient transition of pre-existing securities and other active tax-management techniques.

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A Thoughtful Solution

Parametric has developed a commodity strategy that falls within our Structured Active product group. The strategy seeks to mitigate the risks associated with arbitrary index construction by providing greater diversification into more commodity categories, and it employs systematic rebalancing to keep concentrations from building up. As with other asset classes, this rebalancing, also known as 'volatility harvesting', generates a demonstrated alpha.



To learn more about Parametric's Structured Commodity Strategy, please go to the Knowledge Center on our website and review the 'Commodities' section of our Research & White Papers.

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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), options strategies, and overlay portfolio management. Parametric is a majority-owned subsidiary of Eaton Vance (ticker: EV).

Total AUM:
 \$42 Billion*

*This figure represents the combined AUM of Parametric and its affiliate Parametric Risk Advisors. As of 6/30/2011.

Established:
 1987

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