USING ACTIVE MANAGEMENT AS AN INVESTMENT STRATEGY

WHAT WOULD HAPPEN IF...

What would happen if…

You were invested in the stock market primarily when prices were rising and were safely positioned in a money market fund when prices experienced substantial declines?

Ideally you would:

1. *Experience the superior returns of the stock market over other investments.*
2. *Have less fluctuation in the value of your investments.*
3. *Know that you could liquidate your investments at any time without a major loss.*
4. *Spend less time worrying about your financial assets.*

Since the formation of the stock market, investors have sought ways to avoid down markets, while benefiting from market gains. The investment strategy that resulted has become known as active investment management.

With the development of today's computer technology and the availability of sophisticated market and economic data, active management has gained added importance and popularity among investors.

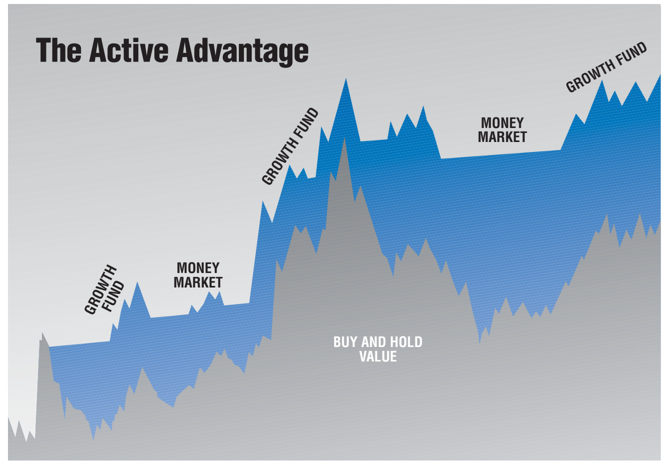
While active management is used to describe a great many different techniques and applications, professional investment managers are today using active management in conjunction with mutual funds and variable annuities to manage client assets. Their results show that active management can indeed reduce the risk of investing in the stock market and improve the opportunity for investment returns.

In fact, assets managed by active money managers are growing at a dynamic rate and are becoming a major component of the financial services industry.[1]

How Active Managers Operate

Active investment management is essentially founded upon research studies indicating what market professionals have long known: that market events are not random and that discoverable relationships exist between different data and the performance of financial markets.

Using the power of computers, investment managers have developed strategies that can take advantage of these relationships. These strategies look for long-term trends in the market's relentless fluctuations to detect periods of sustained up or downward movements. During a perceived "UP" leg of the market, investments are positioned in equities to achieve the greatest return. When the market appears to have topped out, investments are moved into a cash or bond position, until the next "UP period. Not every trade will be a winner and market timing will not beat a buy-and-hold position each period but over time the results can look something like this…



Past performance does not guarantee future results. This is a hypothetical illustration only and its performance is not indicative of any particular investment strategy.

Active models are tested against past market databases and substantiated through actual application in the markets. Professional investment managers then use these proprietary mathematical models to monitor the markets. The models generate "buy" and "sell" signals as the market changes. In response to the signal, the investment manager moves client assets between stock, bond and money market funds, or on a tax-deferred basis in variable annuities offered by insurance companies.

Why Active Management Has Worked

The principle objective of active management is to provide investors with the opportunity to avoid major market price declines. Obviously, if investors can avoid weak periods in the market and participate in the strong, they can also experience superior returns over a buy-and-hold strategy. Studies show that investors can still outperform a buy-and-hold strategy, even if they don't participate in the strongest times — as long as they escape major market declines.

In fact, if you missed the best ten days of the stock market from 1980 to 2002, your return would have fallen from 9.6% to 7.0%. But if you missed the 10 worst days, your return would have increased to 13.4%. Missing both the best and the worst 10 days generated a 10.8% return, or 12% better performance than the buy-and-hold results.2

The reason this is true is the dramatic impact bear markets have on buy-and-hold investments.

The stock market has historically outperformed virtually all other investments, but at the cost of subjecting investors to great volatility. Between 1929 and 2003 there have been 14 bear markets, defined as those periods when the S&P 500 has fallen at least 20%. The average bear market slashed almost 38% from stock prices. Omit the '29 crash, when values declined 87%, and the result is still an average loss of 34%.

During that period, a new bear market began on the average every five years, with an average duration of 17 months. After the bear market bottomed, omitting the distortion of the 1929 crash, it took an average of 3.5 years just to return to a breakeven position.

S&P 500 Index Bear Market Study

September 1929 through 2003

Bear Market	Duration	% Decline	Time Needed To Breakeven
Sept. '29 – June '32	33 months	86.7	25.2 years
July '33 – Mar. '35	20 months	33.9	2.3
Mar. '37 – Mar. '38	12 months	54.5	8.8
Nov. '38 – Apr. '42	41 months	45.8	6.4
May '46 – Mar. '48	22 months	28.1	4.1
Aug. '56 – Oct. '57	14 months	21.6	2.1
Dec. '61 – June '62	6 months	28.0	1.8
Feb. '66 – Oct. '66	8 months	22.2	1.4
Nov. '68 – May '70	18 months	36.1	3.3
Jan. '73 – Oct. '74	21 months	48.2	7.6
Nov. '80 – Aug. '82	21 months	27.1	2.1
Aug. '87 – Dec. '87	4 months	33.5	1.9
July '90 – Oct. '90	3 months	19.9	0.6
Sept. '00 – Mar. '03	30 months	49.0	—

Source: Telephone Switch Newsletter, Summer 1992. Updated by SAAFTI through 2003.

1 "Investors don't have to be big to be smart." Michael Fritz, *Investment News*, Oc.t. 1998, page 1.

2 "Timing Doesn't Have to Be Perfect to Beat Buy and Hold." study of the S&P 500 over a 16-year period by the Society of Asset Allocators and Fund Timers, Inc. Initially released September 2000. Updated through 2003.

Every time investors lose money in a down market, they lose valuable time. If an average bear market reduces the value of your portfolio by 34%, you need a 52% return to return to breakeven.

After eliminating overlapping bear markets, 44 of the past 72 years were spent either suffering through a bear market or returning to breakeven. In other words, investors spent two thirds of their time just trying to stay even. Only one third of the time were they benefiting from the stock market's ability to make their investments grow in value.

Without active management, then, it's clear that over the short term the market is an inefficient vehicle for making money.

Active Management's Goals: To Reduce Risk and Achieve Higher Risk-Adjusted Returns

The objective of active investment management is to reduce risk or fluctuation in an investment account's value, while achieving higher returns than other investments with similar risk. It does so by seeking to avoid declining markets and to preserve capital so that one has more to invest during rising markets.

Many individuals and institutions have chosen to forego the superior performance of the stock market because they are unable or afraid to invest solely for the long term or take the risk of sudden short-term losses. For these investors, active management offers the opportunity to participate in the market with the goal of reducing risk and increasing risk-adjusted returns.

Risk is the variability of an investment's returns over time. The most commonly used method to measure risk is the probability based statistic called "standard deviation", which measures the variability of returns in relation to the long-run average return. The lower the standard deviation, the lower the risk. Another measure of risk includes a fund's volatility versus a market index — measured by its beta.

When risk is figured into their returns, studies have shown that active managers consistently outperform the market. According to a study published in the *Journal of Portfolio Management*[3] in the summer of 1992, 92% of the 25 active managers tracked by *MoniResearch Newsletter* outperformed the market averages in the 1987 collapse, as did 96% during drops in January 1990 and August 1992. Another study shows that active investors can miss up to 20% of the bull market's rise and participate in 20% of the bear market decline, and still equal the performance of a buy-and-hold investor.[4]

While no investment strategy is perfect, and like mutual funds, not every active manager beats the buy-and-hold results, these studies demonstrate that the average active manager has provided superior risk-adjusted returns. It is this fact that is driving the growth of this investment strategy and the success of professional active managers and the investors they serve.

Past performance does not guarantee future results. Complete copies of all referenced studies are available upon request.

3 "Market Timing Works Where it Matters Most… in the Real World" *The Journal of Portfolio Management*, Summer, 1992. Study of 25 market timers' audited market signals from 1985 to 1990.

4 "Why Market Timing Works" *The Journal of Investing*, Summer 1997.