



MSCI MARKET BRIEF

SEPTEMBER 2014 VOL.1, ISSUE 3

BROADER MARKET CONTINUES TO OUTPACE US MUTUAL FUNDS IN AUGUST. SMALL CAPS FEEL THE HEAT.

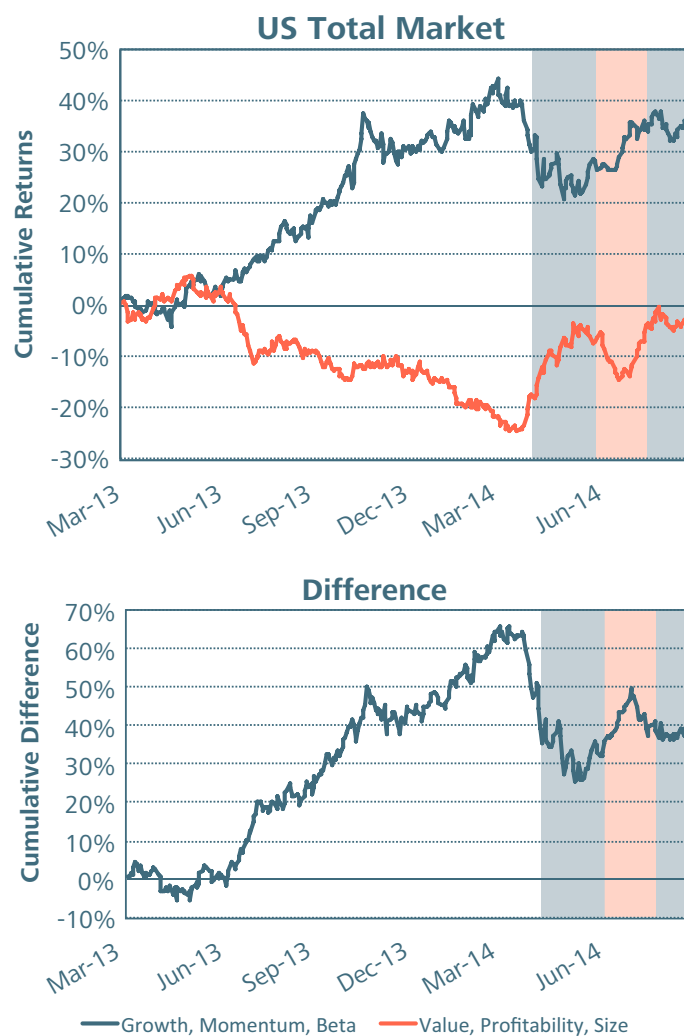
AUGUST MARKET HIGHLIGHTS

The broader markets once again outperformed most mutual funds in August, which underperformed their respective benchmarks on a relative basis. Mutual funds have yet to recover from last spring's style rotation investigated in our July "Market Spin Cycle" paper. Indeed, small cap growth funds delivered the worst relative performance in August, followed by both US Large Cap and Total Market actively managed mutual funds. This collective underperformance extended their YTD slumps.

Using MSCI's US Barra equity models, we analyzed sector and factor performance over the period and found the following:

- The rotation of investment styles we had observed earlier in the year no longer persisted in August. Both Growth- and Quality-oriented styles as a group had flat performance for the month (*Figure 1*)
- The majority of fundamental data-driven styles experienced poor performance in August with Earnings Quality, Profitability, and Value posting negative returns (*Table 2*)
- The winners for the month included Momentum and Prospect, which outperformed in eight out of 10 sectors. High momentum Energy stocks performing especially well (with an information ratio of 2.8). On the other hand, investors ignored highly profitable firms and firms with high cash component of earnings as Profitability and Earnings Quality underperformed in majority of the sectors (*Table 4*)
- While investors seemed to have ignored under-valued, large cap stocks in most sectors, they favored Health Care and Financial stocks where Value and Size posted positive returns (*Table 4*)
- Liquidity, Sentiment and Momentum posted strong positive performance in Total Market and Small Cap segments. However, Long-term Reversal severely underperformed in both segments.
- We note that the strongest performers were highly liquid stocks, especially within the Small Cap segment (with information ratio of 4.5) during the month. Small Cap stocks have outperformed their Large Cap counterparts in August (*Table 3*) as reflected by the underperformance of Size.

US MARKET STYLE ROTATION



Source: MSCI Barra US Sector Model

TABLE 1: US MUTUAL FUND ACTIVE PERFORMANCE BY STRATEGY

YTD PERFORMANCE IS CALCULATED AS OF 08/29/2014

STRATEGY	MAR '13 - FEB '14	MAR 1 - MAY 8	MAY 8 - JUN 30	JULY	AUGUST	YTD
Large Cap	0.8	-1.7	0.4	-0.6	-0.1	-1.6
Large Cap Value	0.7	-1.1	0.0	-0.2	-0.1	-1.6
Large Cap Growth	1.7	-3.2	0.9	0.3	-0.3	-1.6
Small Cap	-2.4	2.6	-1.8	0.6	-0.6	-0.5
Small Cap Value	0.9	1.0	-0.6	0.7	0.0	0.7
Small Cap Growth	0.4	-1.2	-1.0	0.2	-0.8	-3.0
Total Market	1.6	-1.0	0.2	-0.4	-0.3	-1.2
Total Market Value	0.5	-1.2	0.1	-0.6	-0.1	-1.8
Total Market Growth	3.8	-4.7	1.9	-0.2	0.1	-1.4

Source: MSCI Mutual Fund Analytics, Lipper

TABLE 2: RISK-ADJUSTED PERFORMANCE OF SELECT INVESTMENT STYLES

	MAR '13 - FEB '14	MAR 1 - MAY 8	MAY 9 - JUN 30	JULY	AUGUST
Sentiment	(1.3)	2.3	(0.1)	(0.4)	1.1
Momentum	1.1	(1.0)	1.0	0.2	0.6
Beta	0.4	(1.1)	1.1	(0.7)	(0.1)
Residual Volatility	0.1	(1.6)	1.0	(0.9)	(0.1)
Asset Turnover	1.2	0.8	(3.2)	0.5	(0.2)
Size	(0.7)	0.9	(0.6)	1.9	(0.2)
Value	(0.9)	2.2	(0.2)	3.7	(0.3)
Growth	2.8	(1.2)	1.1	1.9	(0.4)
Profitability	(1.7)	2.7	(2.6)	0.8	(0.6)
Earnings Quality	1.9	2.3	(1.8)	1.0	(0.8)

Source: MSCI Barra US Sector Model

TABLE 3: INVESTMENT STYLE RISK-ADJUSTED PERFORMANCE: TOTAL MARKET VS. SMALL CAP (AUG 1 THROUGH AUG 29, 2014)

	Total Market	Small Cap		Total Market	Small Cap
Seasonality	1.9	0.1	Short-term Reversal	(0.2)	(0.2)
Liquidity	1.9	4.3	Asset Turnover	(0.2)	1.0
Sentiment	1.1	1.5	Size	(0.2)	(1.1)
Industry Momentum	1.1	(1.6)	Value	(0.3)	0.1
Momentum	0.6	0.9	Growth	(0.4)	0.3
Prospect	0.6	0.1	Profitability	(0.6)	0.5
Leverage	(0.1)	(0.9)	Earnings Quality	(0.8)	1.0
Beta	(0.1)	0.2	Long-term Reversal	(2.5)	(1.7)
Residual Volatility	(0.1)	(0.2)			

Source: MSCI Barra US Sector Model, MSCI Barra US Small Cap Model

**TABLE 4: INVESTMENT STYLE RISK-ADJUSTED PERFORMANCE BY SECTOR
(AUG 1 THROUGH AUG 29, 2014)**

	UT	CS	TEL	EN	MA	HC	FIN	IND	IT	CD
Seasonality	(0.0)	1.7	(1.3)	(0.9)	0.0	1.3	0.9	(0.1)	3.2	(1.5)
Liquidity	(0.2)	0.3	2.2	1.5	0.3	1.3	(0.4)	(2.4)	2.5	2.2
Sentiment	(0.1)	0.0	(0.5)	0.5	1.7	0.4	1.1	0.7	(0.1)	1.9
Industry Momentum	(0.6)	0.0	(1.5)	0.0	0.3	1.6	(2.3)	0.5	(0.3)	0.3
Momentum	(1.0)	0.5	0.6	2.8	1.3	1.0	0.3	1.3	0.2	(1.0)
Prospect	0.4	1.5	1.5	0.3	0.1	0.2	(1.5)	2.2	0.8	(0.5)
Leverage	(0.8)	(0.8)	(0.7)	(0.1)	0.5	(0.1)	0.8	1.8	(0.8)	(0.4)
Beta	(0.9)	(1.4)	(0.6)	(1.3)	(0.3)	1.1	0.5	1.1	0.4	(1.8)
Residual Volatility	1.1	(2.4)	(1.0)	(0.3)	0.4	1.3	0.3	0.7	(0.6)	(0.6)
Short-Term Reversal	(0.0)	(0.2)	0.8	(0.3)	(2.1)	(0.3)	2.5	(0.3)	(0.3)	1.0
Asset Turnover	(0.6)	1.5	0.5	(0.2)	2.4	(0.4)	0.7	(0.6)	(0.0)	0.7
Size	(0.2)	(1.4)	(0.7)	(2.0)	(0.7)	0.8	0.2	(0.2)	(0.5)	1.1
Value	(1.5)	(1.4)	0.0	0.2	(2.1)	0.9	1.4	(0.4)	0.6	(0.7)
Growth	(0.4)	(0.7)	0.9	0.1	0.2	(0.5)	0.0	0.6	1.0	(1.5)
Profitability	(1.0)	(0.7)	0.4	(0.2)	(0.2)	(0.4)	0.0	(0.5)	0.9	(1.2)
Earnings Quality	1.9	(1.4)	(0.7)	(0.1)	0.5	(0.0)	(0.9)	1.5	0.5	(1.2)
Long-Term Reversal	(0.1)	0.2	0.7	(1.4)	(0.4)	(2.8)	(0.2)	(1.4)	(0.5)	(1.3)

Source: MSCI Barra US Sector Model

MODELS USED — BARRA US SECTOR EQUITY MODELS

The Barra US Sector Equity Model family is designed for managers who invest within specific sectors in the US equity market. Leveraging MSCI's experience in building single-country, multi-factor models and indexes, this family of models consists of 10 sector-specific models and an integrated version that combines the individual sector models. Each model incorporates the latest research and innovation in risk modeling, including Systematic Equity Strategies, Volatility Regime Adjustment, and Optimization Bias Adjustment. The Barra US Sector Equity Model family aligns with the investment strategy and investment universe to deliver insight into drivers of risk and return.

KEY FEATURES

- **Aligned with US sector-specific investment strategies.** The models are estimated from a universe that resembles the investment universe for a US sector-specific investment strategy. Each model has sector-specific factor returns for improved insight into the drivers of risk and return of US companies relative to their sector.
- **Incorporates new factors based on Systematic Equity Strategies.** The models deliver improved forecast accuracy and captures unique sources of risk from common sources of return.
- **Broad coverage of US securities.** As of October 2013, coverage is over 20,000 securities including IPOs, pink sheets, OTC securities, and over 4,500 foreign-listed shares of US companies.
- **Estimated daily for improved insight.** The models are estimated daily for improved risk monitoring, portfolio construction and rebalancing, 'what-if' and stress analysis, and backtesting. Factor exposures, correlations, and specific risk are updated daily.
- **Enhanced beta estimation** incorporates shrinking to industry betas to provide improved stability and decrease dispersion. This methodology can reduce errors in the predicted beta estimates.
- **Optimization Bias Adjustment** improves risk forecasts for optimized portfolios. Clients can reduce forecasting bias by scaling volatility during periods of under- and over-forecasting.
- **Volatility Regime Adjustment** allows clients to calibrate factor volatilities to current levels, resulting in faster response to market trends. This methodology can reduce the under-prediction of risk when entering a period of increased volatility and the over-prediction of risk when exiting a period of reduced volatility.

- **Updated specific risk model** that incorporates Volatility Regime Adjustment and Bayesian Adjustment techniques for improved forecast accuracy.
- **Utilizes the US Country factor** to isolate the market and industry effects, which allows clients to capture correlations between industries. The models use 60 industry factors based on the Global Industry Classification Standard (GICS®).
- **Model history available** from July 1995.
- **Model Receipts** are updated daily and posted on the Client Support site. The receipts provide a summary of the model quality controls, offering transparency and insight into model reaction from changes in underlying data.
- **Available in Barra Portfolio Manager and Barra Models Direct.**

MOTIVATION

Each sector has a unique risk and return profile. Sector profiles are different from the total US market and from each other. The table below exhibits characteristics of the 10 economic sectors defined by GICS® within the MSCI USA IMI. An investment manager focused on a sector-specific investment strategy can gain better insight and construct more meaningful portfolios through alignment of the Barra US Sector

Equity Models and the investment universe of their strategy.

MSCI USA IMI BROKEN DOWN BY GICS® SECTOR (AS OF SEPTEMBER 30, 2013)

SECTOR	# OF STOCKS	WEIGHT IN MSCI USA IMI	AVERAGE MARKET CAP+	DIV. YIELD*	ROE*
Information Technology	407	18.07%	8,755	1.58%	23.56%
Financials	514	17.08%	6,494	2.25%	10.92%
Consumer Discretionary	368	13.03%	7,408	1.26%	25.68%
Health Care	284	12.61%	8,460	1.58%	19.18%
Industrials	340	10.96%	6,547	1.82%	28.72%
Energy	156	9.82%	12,022	2.06%	15.06%
Consumer Staples	111	9.06%	16,869	2.76%	35.93%
Materials	134	3.83%	5,629	2.03%	16.46%
Utilities	78	3.24%	7,681	3.88%	9.47%
Telecommunication Services	32	2.29%	13,904	4.49%	4.42%

+ In millions of USD * Source: MSCI Fundamental Data

MODELS USED — BARRA US SECTOR EQUITY MODELS

SYSTEMATIC EQUITY STRATEGIES

Incorporating Systematic Equity Strategy factors helps identify persistent market anomalies, track the seasonality or market-timing opportunities, and improves portfolio construction and monitoring. The following Systematic Equity Strategies are available in the Barra US Sector Equity Models.

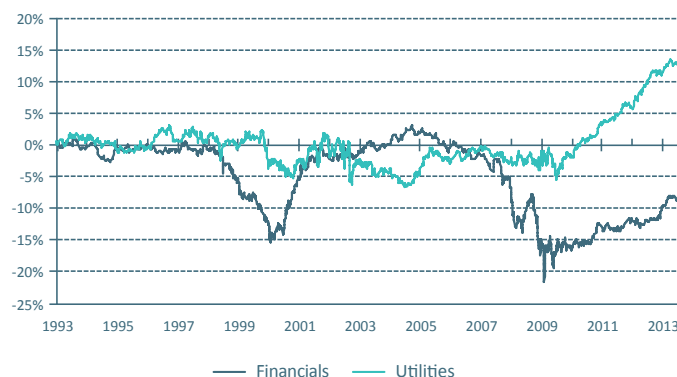
VALUATION	QUALITY
Value Book-to-Price Sales-to-Price Cash Flow-to-Price Trailing Earnings-to-Price Forward Earnings-to-Price Dividend Yield	Earnings Quality Accruals Cash Earnings Variability of Sales Asset Turnover Profitability Return on Equity Return on Assets Sales Profit Margin EBIT to Enterprise Value
SENTIMENT	MOMENTUM
Sentiment Analyst Ratings Changes Analyst Estimate Revisions	Stock Momentum Industry Momentum Seasonality Short-term Reversal Long-term Reversal Prospect Skewness Drawdown Lottery

KEY BENEFITS

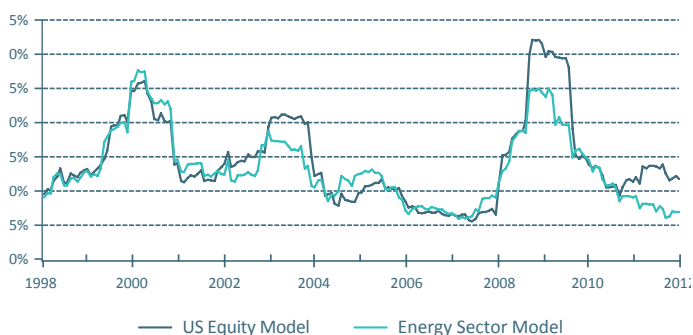
- Each Sector is Unique** – Sector models are designed to evaluate risk and performance of sector-specific portfolios, because they incorporate sector-specific dynamics. The models are **aligned with the investment universe** and lead to risk and performance attribution that **accurately reflect the manager's investment philosophy**. The first figure shows the cumulative performance of the Leverage factor for the Utilities and Financials sectors. The differences in factor returns between these two factors illustrate the value that sector models capture. The second figure shows the performance of the Barra US Energy Sector Equity Model compared with the complete Barra US Equity Model when used in a minimum volatility backtest.

- Integrated Model for Universal Coverage** – An integrated model is available to get an aggregated perspective when evaluating multiple sector-specific strategies or managers. The Barra US Sector Integrated Model provides a total market perspective while recognizing the uniqueness of risk and return characteristics of each individual sector.

LEVERAGE FACTOR: CUMULATIVE PERFORMANCE IN THE FINANCIALS AND UTILITIES SECTORS



REALIZED VOLATILITY OF MINIMUM VOLATILITY PORTFOLIOS FOR THE ENERGY SECTOR CREATED WITH BARRA US ENERGY SECTOR EQUITY MODEL AND BARRA US EQUITY MODEL



MODELS USED — BARRA US SMALL CAP EQUITY MODEL

The Barra US Small Cap Equity Model is designed for managers who invest in small capitalization companies in the US. It leverages MSCI's experience in building single-country, multi-factor models and indexes, and incorporates the latest research and innovation in risk modeling, including Systematic Equity Strategies, Volatility Regime Adjustment, and Optimization Bias Adjustment. The Barra US Small Cap Equity Model aligns with the investment strategy and investment universe to deliver insight into drivers of risk and return.

KEY FEATURES

- **Aligned with US small cap investment strategies.** The model is estimated from a universe that resembles the investment universe for a US small cap investment strategy.
- **Incorporates new factors based on Systematic Equity Strategies.** The model delivers improved forecast accuracy and captures unique sources of risk from common sources of return.
- **Broad coverage of US small cap and micro cap securities.** As of October 2013, coverage is over 20,000 securities including IPOs, pink sheets, OTC securities, and over 4,500 foreign-listed shares of US companies.
- **Estimated daily for improved insight.** The model is estimated daily for improved risk monitoring, portfolio construction and rebalancing, 'what-if' and stress analysis, and backtesting. Factor exposures, correlations, and specific risk are updated daily.
- **Available in daily, short-, and long-term horizons** for alignment with the investment strategy and portfolio turnover.
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- **Updated specific risk model** that incorporates Volatility Regime Adjustment and Bayesian Adjustment techniques for improved forecast accuracy.
- **Utilizes the US Country factor** to isolate the market and industry effects, which allows clients to capture correlations between industries. The models use 60 industry factors based on the Global Industry Classification Standard (GICS®).
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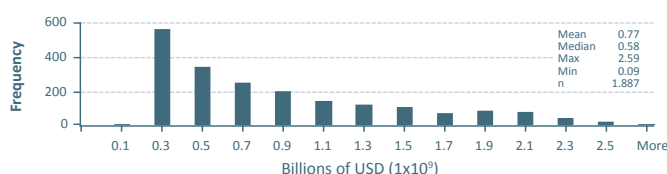
MOTIVATION

Small cap securities in the US have significantly different performance from the broader US market and therefore exhibit different risk and return characteristics. An investment manager focused on the US small cap securities can gain better insight and construct more meaningful portfolios through alignment of the Barra US Small Cap Equity Model and the investment universe of their strategy.

MSCI USA SMALL CAP VS. MSCI USA

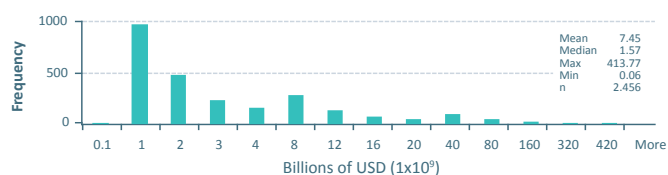


ESTIMATION UNIVERSE MARKET CAP DISTRIBUTION BARRA US SMALL CAP EQUITY MODEL AS OF FEBRUARY 2013



MODELS USED — BARRA US SMALL CAP EQUITY MODEL

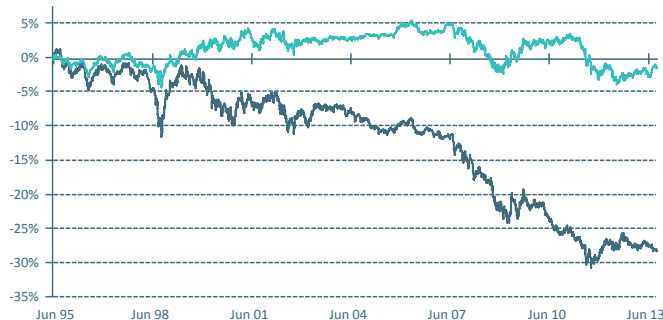
ESTIMATION UNIVERSE MARKET CAP DISTRIBUTION BARRA US EQUITY MODEL AS OF FEBRUARY 2013



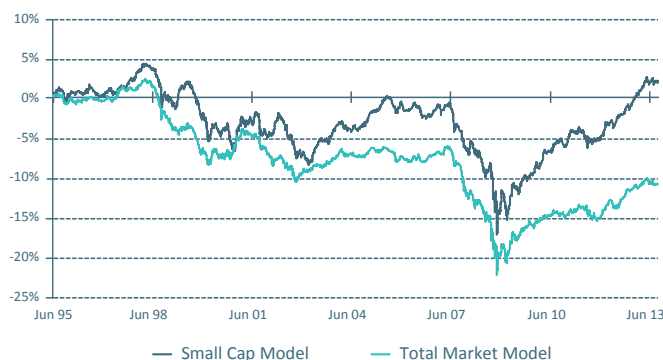
KEY BENEFITS

- Investment Universe Alignment** – The Barra US Small Cap Equity Model can provide transparency and insight into risk and performance of strategies focusing on small cap assets and **more accurately reflect the manager's investment philosophy** versus a broad-based risk model. The figures below compare the performance of the Liquidity and Leverage style factors between the small cap and the total market, and show the performance of the style factors for the small cap model over time.
- Systematic Equity Strategies** – Incorporating Systematic Equity Strategy factors helps to identify persistent market anomalies, track the seasonality or market-timing opportunities, and improves portfolio construction and monitoring. The following Systematic Equity Strategies are available in the Barra US Small Cap Equity Model.

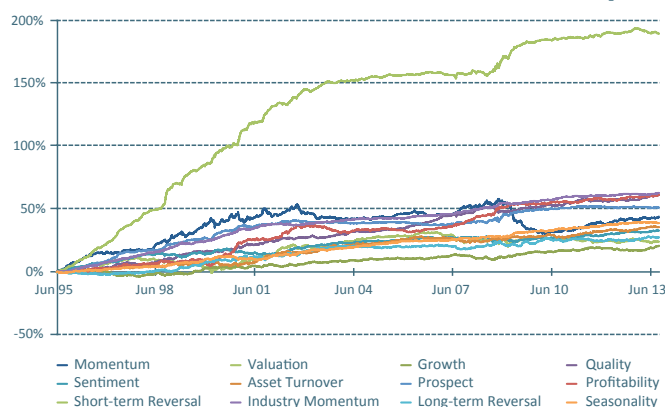
SMALL CAP VS. TOTAL MARKET LIQUIDITY FACTOR



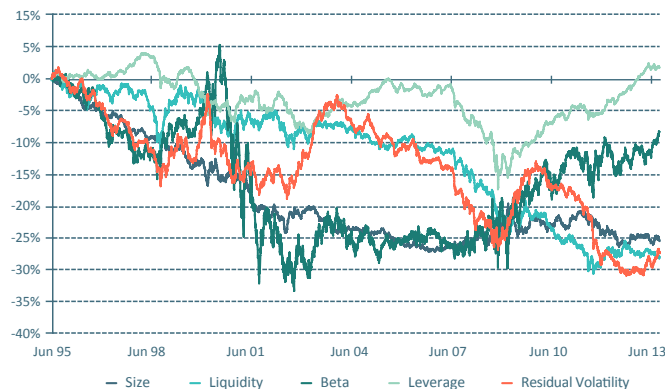
SMALL CAP VS. TOTAL MARKET LEVERAGE FACTOR



CUMULATIVE PERFORMANCE OF SYSTEMATIC EQUITY



STRATEGY FACTORS FOR US SMALL CAP



CUMULATIVE PERFORMANCE OF OTHER STYLE FACTORS FOR US SMALL CAP

VALUATION	QUALITY
Value Book-to-Price Sales-to-Price Cash Flow-to-Price Trailing Earnings-to-Price Forward Earnings-to-Price	Earnings Quality Accruals Cash Earnings Variability of Sales Asset Turnover Profitability Return on Equity Return on Assets Sales Profit Margin EBIT to Enterprise Value
SENTIMENT	MOMENTUM
Sentiment Analyst Ratings Changes Analyst Estimate Revisions	Stock Momentum Industry Momentum Seasonality Short-term Reversal Long-term Reversal Prospect Skewness Drawdown Lottery

WHAT WE OFFER

BARRA PORTFOLIO MANAGER 3.9

Barra Portfolio Manager is a market-leading platform for the professional equity investor community to help them design, develop and manage their investment strategies.

The latest release of Barra Portfolio Manager represents a significant milestone in our flagship investment management platform and includes new features like Custom Factor Attribution, High Volume Reporting, Optimizer 2.0 integration and a new flexible user interface.

AVAILABLE NOW

Custom Factor Attribution – Designed for clients who want to customize the factor structure of the risk model to match their investment process

- Permit a user to give meaningful attributions of stochastic risk models by mapping to fundamental risk models.
- Facilitate transitions from older models to the newest risk models by applying the factor structure of the legacy model to the new model's risk forecast.
- Replace a risk model's industry factors with a local market industry classification.
- Remove or merge factors to make the risk attribution more meaningful. Long/short equity investors typically prefer removing the World/Country factor and attribute market risk to a more intuitive customized factor block (industries or countries).
- Replace the factor structure entirely with userdefined factor exposures.

BARRA MODELS

Our model roadmap delivers MSCI's new approach to risk modeling: Systematic Equity Strategies (SES) that can help clients with improved risk forecast accuracy and capture unique sources of risk from common sources of return. SES factors are now included, in addition to the standard Barra style factors, market factor and industry-specific factors.

Together these illuminate previously hidden sources of risk and return, resulting in portfolios with less attributed specific risk. The SES factors also allow users to measure portfolio sensitivities to potentially crowded trades and positions, and uncover potential seasonality effects. During times of market stress, this crowding may result in extreme levels of risk.

SES factors help to:

- Capture previously hidden sources of risk and return that managers bet on, which result in greater transparency within portfolios.
- Improve the accuracy and explanatory power of a risk model, especially during periods of economic crisis. Bring more insight into portfolio construction.
- Provide a wider view into the sentiment around a stock, by matching the stock against widely followed attributes.
- Identify persistent market anomalies and track the seasonality or market-timing opportunities around systematic equity strategies.

FEATURED RESEARCH

- Historic Drawdowns – A Review of Recent Mutual Fund Active Performance
- Market Spin Cycle – The Rotation Continues...
- The Market Spin Cycle: Uncovering Style and Sector Rotation in a Flat Market

AVAILABLE NOW

- Barra Japan Equity Model (JPE4) | Barra Korea Equity Model (KRE3) | Barra US Small Cap Equity Model (USSC4)
- Barra Emerging Markets Equity Model (EMM1) | Barra US Sector Equity Models (USSM1) | Barra South Africa Equity Model (ZAE4)

COMING SOON!

- Barra US Equity Model (USE5) | Barra Asia-Pacific Equity Model (ASE2)
- Asian Single-country Models including Hong Kong, India and Taiwan

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