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MANAGEMENT DISCUSSION SECTION

Company Representative

Welcome to Financial Research Perspectives with FactSet. Today, we'll be sitting down with Satya Pradhuman, Director of Research at Cirrus Research, and author of Small-Cap Dynamics, a guide to small cap investing for professionals. Cirrus Research specializes in idea driven, strategic analysis and insights for mid, small and micro cap investors, as well as delivering quantitative products for managers focused on this less liquid under followed part of the equity market.

Satya joins us today to discuss Cirrus's outlook for the market, particularly with regard to mid, small and micro cap investors. Satya, welcome to our show.

Satya D. Pradhuman, Chief Executive Officer and Director of Research, Cirrus Research

Great. Thank you very much.

<Q>: I'd like to start today by asking you to explain Cirrus's investment principles for our listeners.

<A – Satya Pradhuman>: Sure. We are a strategy research firm. We focus on the riskier assets within the equity market. For the most part this really focuses on developed markets, looking at smaller stocks. Much of the work and much of our strength tends to be very U.S. focused and in the last year, year and a half we've also been making strides in the European markets in the launch of the product and the firm, we spent quite a bit of time building out infrastructure on the U.S. equity markets.

In the last couple of years, we've been able to build out a good amount of industry sector work, work that goes back 40 years of time series and industries and sectors that have been hand cleaned. We think this is probably a real advantage for investors that are serious about the small mid-cap arena.

<Q>: Your firm uses a multi-factor ranking methodology, as well as other quantitative analysis strategies in your research, can you explain to us a little bit more about your MFR, as well as your other quantitative strategies that you might be using?

<A – Satya Pradhuman>: Sure. We think adding the quantitative tools gives us a competitive advantage. I find that, when we look at top down macro research, I think one of the soft points for such work is that sometime there is very little practical takeaway. And I think it behooves the strategist to really take the logic and the good idea down to a very pragmatic level. And as a result the quantitative tools allow the Cirrus researchers to really get very granular. So the framework what we've built out is multi-factor back test routines that allow us to develop custom portfolios for clients.

So some of that work also shows up in the research reports, for instance, recently we've done some work on staples and we found industries within this consumer staples area that was attractive. We were able to use our multifactor product to be able to rank order stocks most attractive to least attractive.

As you can see the idea about talking about let's say how attractive food companies are, it sounds good and maybe that's a great starting point. But to be able to then take a look at the food companies themselves and rank order it, that's maybe even more useful.

And so I think that's how some of these quantitative tools are allowing us to service our clients better. It also though, from a Director of Research standpoint, it's an important tool for me to work with the analysts.

What it allows me to do is to get – let's say, they've got a very good idea, to have them take it a step further. Sometimes seeing the details of that analysis at the stock level allows you to really clarify the strategy in itself. So for several reasons, we think the quantitative tools are very useful and the clients have taken to them nicely.

<Q>: Great. So I want to move into more discussion of your research. In your research you've talked about the current period of relative stability in the market as a bear market rally. Would you mind explaining to our listeners what shapes this outlook?

<A – Satya Pradhuman>: Sure. There's a lot of talk and debate about whether this recent bounce in the equities is a market bottom or a bear market rally, dead-cat bounce, a number of phrases like that. At the end of the day, we think that this is – we are in the stages of some sort of a bear market rally, a bounce. And there were three things that drove us to this. We published some pretty strong work on this back in mid-March and we were fortunate enough to flag the risk that you could see a bear market rally.

Three things drove us there. One was the expectations on earnings had been cut sharply. This is something that we were – that was a curious factor in 2008 and what was interesting. And we did put out a report that was subtitled "Talking Bearish vs. Acting Bearish", and the message there was that the sell side forecasts were just so far away from reality that most everyone was talking bearish but the forecasts were just buoyant. Along comes November, December and it's almost as if sell side analysts globally – we also noticed this in Europe – it's almost like they took a hammer to their estimates. And we saw a sharp collapse in earnings forecasts.

Now, in some ways that could scare the average onlooker, which is, oh my gosh, sell side analysts are cutting estimates. The other side of it though is, wait a second, earnings hurdle rates are now much lower. So if you go into the earnings season, you could end up seeing real companies surprise to the upside. Again, stock prices move not just because is the company in good shape or bad shape but is the company delivering numbers well below or well above expectations. And so we thought that was a really important data point that you now had expectations that were cut. So you could see – even though we are not out of the woods, you could see stocks and companies in general report earnings that may be healthier than usual.

Two, one of our proprietary risk measures called the CRX, Cirrus Risk Score, basically tell us that we were entering, as we entered this year the start of a third year of a pullback in risk taking, a sharp pullback. Now typically when you see the market pull back in risk taking what we have learned, now this is about 30 years worth of data we've got, typically that pullback in risk taking is 12, 18 months in duration. The fact that we're entering our third year, says that, okay if you are nervous about the world you've got a lot of company. So a lot of bad news might be discounted.

And the third element that really drove this call for a bear market rally was this idea that the high yield market is very linked to the small cap market. That market was already rallying and typically when the high yield fixed income market starts to settle, stabilize or rally, by definition, cost of funding is improving, so it usually fuels a positive move in the equity market. You typically see the most significant move in the Russell 2000 or the smaller companies. And as a result I think we've been positioned more correctly because of some of these indicators.

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<Q>: I wanted to ask you a follow-up to that which is: you mentioned you have 30 years worth of data that you look at. Is there anything in that data that shows us a situation that is very similar or near to the one that we're in currently?

<A – Satya Pradhuman>: That's a great question. I think a lot of our clients are always sort of, they are racking their data, their experience for where are we. What is this most like? And from the risk data that we've got, the only period where the risk appetite has pulled back more sharply for a 12-18 month period was really in 1980-81, in the sharp recession in that period where risk appetites really got pulled back severely for a solid three years.

I think the sobering message here is that, okay, this not the '89-'90 S&L crisis. And because that crisis we ended up seeing a pull back in risk taking but it was short lived compared to what we're going through now.

And to some extent, what the data also said is that, wow, we have had periods even in the recent history where the risk appetite could keep getting pulled back for a longer period than 12-18 months. As a research team, I think we were very fortunate not to assume that, okay, it's past 12 or 18 months; we're out of the woods, because this is what we've seen in this history. I think we do have a respect for the condition we are in and we do think this is unique and global. And as a result I think it kept us much more conservative and wary of the environment.

<Q>: So tell me more about portfolio position. So let's say we're in a bear market rally. We're experiencing a dead cat bounce. What can investors do to navigate through this short-term rally in the market?

<A – Satya Pradhuman>: Great question. I think to some extent, I don't think we'll be smart enough to forecast how it ends. And at the same time, what we're now recommending to clients because we've seen the Russell 2000 recoup nearly 50% of losses, so the index has bounced sharply. I think March 9 was the bottom.

The idea here is – we are not going to be smart enough to forecast how this dust eventually settles but what we do think makes sense based on the indicators we've got is that we would start to take profits on stocks that have run sharply. At the end of the day, what I think has gone on is that we are now pricing in properly the stabilization of the credit crisis and as a result, the equity market should have moved sharply on the stabilization of the credit crisis.

If that is settling, what we now turn to is the play out in the real economy and that is earnings are likely to remain lackluster for quite some time. So, the challenges that firms have had in terms of finding funding, that has some latency to it. As a result, we've gone through a sort of bear market rally pricing in some of our worst fears. We've seen the markets snap back, potentially forecasting that the credit cycle is about to settle and at this point now we think that certain stocks have moved so sharply that it makes sense for investors to take profits.

Much of our work has been geared towards isolating ideas or themes on where to take profits or where to sort of reinvest. So, we think that the move has been sharp, some of the indicators still tell us that it's positive equity backdrop. So, this bear market really could be stronger than most of us imagine. And yet because we are not smart enough to forecast how it ends out we do want to take profits on low quality situations that have gotten maybe too expensive. So I think that's pragmatic.

The other side of it from a strategic standpoint is to also suggest to clients to lower their cap bias. What we are finding is that institutional investors are potentially holding on to too liquid stocks and if as the economy settles and the credit market cycle settles what you typically see coming out of this is a very broad rally and so the areas of the market that would move more and we've seen maybe

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hints of this are already in the lower cap section. So, to some extent you want to position more broadly than your peers. And as a result, we do think you start taking profits focused on firms that are free cash flow generators, that are not at risk for refunding and refinancing. And at the same time, from a portfolio standpoint, lower the cap bias.

A lot of the fund managers I think to find protection have erred towards liquidity and what we could show in our work is they're not getting rewarded for it, that managers, the last time they got rewarded for holding the highest cap or most liquid names was actually back in 2007. So – and it hasn't worked in some time, but we think, we look forward here if the credit cycle settles and the economy bottoms, you're going to go into a low cap bias. So you want to have a lower capitalization bias going into the next 12, 18 months.

<Q>: Okay. So I wanted to move to a question about policy. You mentioned that the rally could be stronger and more sustained then. This could have something to do with the policy responses that have been put into place, so things with the TARP and the TALF; might that dampen the negative impact and might it force a faster recovery, or do you think that's only going to kind be a temporary fix in this case?

<A – Satya Pradhuman>: We struggle with the policy responses. We think that's a risk to our call, which is the government keeps putting out a plan to rescue the banks and settle the credit system. And the initial stages did not work very well, in fact, we saw how the markets subsequent to the initial stages of support collapsed 20, 30, 40%. At some point, they're going to hit the target, and what I mean by that, at some point these policy responses will settle the credit markets. We may actually be going through some of that now.

Does it end up causing a more severe rally? I think that's exactly what's underway. It does seem as if this bounce, this sharp move in the Russell 2000 as an example of almost 50% in about six, seven weeks, that is not the stuff we've seen historically. So this is already an outlier sort of recovery or bounce in the market. So to some extent the sheer dosage of policy responses are so dramatic that at some point it has to inflate equities, and to some extent maybe that's what we're going through right now.

It's really tough though to sort of separate out what is policy, and what is fundamental; there's some real noise in the channel here.

<Q>: I wanted to ask you, do you think policy moves to this point, so some of the programs that have been in place up until now have had a different impact across the caps? So have they had more impact on smaller, mid and micros?

<A – Satya Pradhuman>: What we've observed is that you see riskier firms, smaller less liquid firms, sell off in the initial rounds of this crisis as it was forming in 2007. So the initial wave actually affected the smaller companies market much more, it affected smaller banks much more, and what's ironic is as we went into 2008, investors began to realize that this was much more of a severe issue and in fact some of the concerns were centered in the large banks. So we ended up seeing more of a correction than a collapse in the large bank results.

And so if you fast forward through the policy responses, what we are seeing is that we've almost seen sort of a reflation of equities across the board and what's going on is we've seen a more sharp bounce among the lot smaller companies. It's very hard though at this point to say that the responses should favor one group over another. Historically, what we have seen is that if you do get the credit cycle drying up, it will affect smaller companies more so, which we did see, and as the credit cycle settles you typically see the riskier firms bounce more sharply. So I suspect that

that's what likely to play out here. I don't think its going to be terribly different and so I think what's catching all of us off guard is just how dramatic the environment has been.

<Q>: Let's move from the trouble at home to the trouble abroad. Your paper on April 24 addresses the discrepancy between the health of the European banking system and health of the U.S. banking system. So for instance, European banks have rid themselves of approximately 20% of their bad loans according to your research as opposed to 50% for the U.S. Tell me more about the positioning of the European Union's banking system during this crisis?

<A – Satya Pradhuman>: We think this is becoming a very important point this late in the cycle and as the banking system is, across all the nations are addressing their concerns, we think the euro might be a very interesting component to the equity puzzle and the idea here is that when we looked at some of the forecasts generated by the IMF, their reports, they are basically telling us that the European banks, Western European banks are much more behind on addressing the bad loans and as a result we do think this is going to come home to roost in terms of how the euro behaves.

I draw this linkage to the struggles we in the U.S. have faced in our banking system and the way we tell this is that, think about the struggles the American people have had in writing checks to the big banks here in the U.S. Okay, now how does it play out if the Germans and the French are being asked to contribute to stabilize Austrian or Spanish banks? So our message is that the challenges that we have faced to support our own banks are going to be amplified because it's not just one country. And this is because the Western European banks are further behind we think that the euro faces more pressure in the next six, twelve months.

The second point is that, the Western European banks have severe exposures to Eastern Europe, which is in very difficult straits. So as a result, when we bring these two data points together, we actually see a struggle among the European Nations and how they address their challenges. The fact that it's more of a debate could end up putting more stress on the euro in the next six, twelve months. As a result, and this may sound a bit perverse, but as a result the dollar could actually strengthen through this challenge.

<Q>: How do you see the euro and the dollar moving in the next maybe six to 12 months? Should investors be concerned about their exposure to European stock?

<A – Satya Pradhuman>: Good question. I think the concerns to the euro, there are several ways to think of framing this as a trade. What we've jumped on as a team collectively. We think one of the most interesting ways to trade this, is to now take profits on euro exposure. So what if the – there are many ways to play this. But what are the U.S. firms, sectors, industries that have severe exposure to European markets?

So if the euro weakens that's potentially where you'll see the most significant hiccup to earnings and currency translation. In the work we have done – we've done some of this on the large cap side and the smaller cap side, what's interesting is that the smaller companies in the U.S. have less exposure to Europe. However, it's that more clustered exposure.

So when we look at the smaller cap landscape; sectors like technology both in the software, hardware area; materials, specifically chemicals, and within the industrials, a few industries there, those are pockets where we see pretty sharp European exposure. So the idea here is that if the euro weakens you end up seeing adverse economic growth there. These are pockets within the U.S. equity, U.S. centric portfolio that could create the most risk.

Now this is timely because we've seen a sharp move up in equities here and clients are clearly looking for places to take profit. So this ends up being a really wonderful way to frame out, how do

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we take profits? And so the idea here is that we're more right than wrong about a weaker euro trend in the next 12 months. It ends up pointing us to about four to five industries that we should focus on, and this allows us to minimize or mitigate some of that risk.

<Q>: So we spoke today about the U.S. market's current state, the impact of policies as well as the trouble abroad for the banking system. Given all of those factors, what is your perspective on the sector outlook? What sectors would you say have the best positioning right now, and which would you say have the worst?

<A – Satya Pradhuman>: A lot of our absolute valuation work we've done tells us that we're probably, maybe slightly overvalued in aggregate. But if you break that work down into the sectors, this is really where I think the active investor gets – the active investment policies become much more interesting. If we look at sector valuations what we're seeing is a fat-tailed effect, we've got certain sectors with 20, 30% undervaluation signals, and then there are other areas where they're 20, 30% overvalued.

On the tails, what we continue to see is undervaluation – a few sectors like consumer services and healthcare appear to be the most undervalued and then conversely, sectors like REITs and the industrials appear to be the most overvalued. So we think that this – it's an interesting period because we have been so shaken by how dramatic this environment is. It almost forces you to not want to take any risk or to not think about active investments.

And yet because of the dislocations we've seen if ever you are going to pretend to be an active manager, this is it. So we think this is – as challenging as this is, we see this as a really important time and we believe that the stars of the next decade in investment management are going to be born in this next 12, 18, 24 month period, the dislocations are that severe.

<Q>: Would there be anything else that you would like to add for us today?

<A – Satya Pradhuman>: I think in short, we continue to look carefully for opportunities and clearly look to flag risks for our clients. One of the more interesting trades that we recently published on were the consumer staple sectors and in that sector we think there is a really important relative value trade that benefits food companies and potentially places at risk the grocers and the drug stores and the logic here is that the food companies appear fairly cheap and in addition to that the input costs are falling off sharply, so we think that – when you are looking for good companies you always want to find companies that are improving margins and what we can show is that as the PKI has been falling off, it's the ultimate forecast for rising margins in the food area. So we think that's another interesting segment to be focused on in this area.

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Okay. Great. Well thank you so much for all of your time today. I am so glad that you could join us.

Satya D. Pradhuman, Chief Executive Officer, Director of Research – Cirrus Research

Thank you. You are very welcome.

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Thank you for listening. Be sure to join us in coming weeks for a discussion with Michael Grupe with NAREIT. Today you heard Satya Pradhuman mention the overvaluation of REITs. We will be talking about this and many more topics with Michael. We welcome your feedback. Email us at podcast.factset.com for more information or to leave comments. Also remember to rate our podcast in iTunes. Thank you.

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