Blue Heron Strategy Indicators

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For additional information please refer to the Blue Heron website at www.blueheronconsulting.com.

Overview

A Blue Heron Strategy Indicator (BHSI) is a performance index that reflects the average return achieved by a set of active managers that adhere to particular equity investment strategy or philosophy. BHSIs are designed for use in return-based style analysis. At present, there are 12 BHSIs available in daily and monthly return series:

Blue Heron Value

Value-Deep Value
Value-Dividend Yield
Value-Discounted Value
Value-Midcap Bias

Blue Heron Core

Core-Value Bias
Core-Neutral
Core-GARP
Core-Growth Bias
Core-Midcap Bias

Blue Heron Growth

Growth-Consistent Growth
Growth-Earnings Momentum
Growth-Midcap Bias

Purpose

The purpose of the Blue Heron Strategy Indicator (BHSI) series is to enable efficient and accurate assessments of investment manager biases that result from specific investment philosophies and strategies. Since different strategies (even within the

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Growth style, for example) can result in meaningfully different performance patterns over short time periods (e.g. three years or less), an accurate understanding of a manager's strategy biases is important to making accurate assessment of manager skill. An accurate understanding will also help a manager's prospects and clients develop more appropriate performance expectations and help them to be more patient during periods of poor performance attributable to the manager's investment strategy.

Defined

Each Blue Heron BHSI reflects the mean return (gross of fees) of managers that focus on implementing a particular investment strategy. Blue Heron identifies these managers through qualitative analysis and an analysis of portfolio characteristics and holdings. Each indicator represents the mean return of typically 3 to 15 managers.

Our goal is to develop a return figure that is most representative of managers that adhering to a particular investment strategy.

- Blue Heron determines the membership of each BHSI group. We manage the membership of the group over time to provide the best indicator of strategy return.
- We include managers that are focused and adhere to the identified strategy regardless of the market environment.
- We avoid managers that hold stocks simply for diversification reasons.

While a Blue Heron BHSI can be thought of as a special type of universe mean, there are key features that differentiate a BHSI from traditional universe means.

Blue Heron Strategy Indicators	Traditional universe means
• BHSI members are selected to represent the subset of managers that employs a particular strategy. We favor manager purity over sample breadth. • Blue Heron does not offer quartile breaks within the groups.	• Universes are developed to reflect the entire opportunity set of a particular type of manager or portfolio • Quartile breakpoints are important

Compared to style universe means, BHSIs:

- Typically have higher betas and volatility
- Are available two business days after period end
- Are available in daily and monthly series

These features make Blue Heron Strategy Indicators more useful than universe means for returns-based style analysis.

Uses

Blue Heron Strategy Indicators can be used in a variety of ways.

- As performance benchmarks – They can be used individually, much as one would use a style benchmark. If a manager is believed, for example to be

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a Consistent Growth manager, a comparison to the Consistent Growth BHSI indicator would provide a perspective on how the manager has done relative to the focused Consistent Growth managers Blue Heron has identified.

- To determine strategy biases – BHSIs used as indexes in a return-based style analysis to create a style benchmark (what Blue Heron calls a strategy profile) can identify a manager's strategy bias and any changes to those biases over time. Blue Heron has done the qualitative and holdings research on key representatives of each strategy, and the BHSI returns leverage this work to other managers with similar performance patterns. The perspective BHSIs provide complements an analysis of portfolio holdings and qualitative manager research.
- To determine the value a manager adds above their strategy biases – In a return-based style analysis, the return of the mix of BHSIs as the style benchmark (or strategy profile) determined in the analysis can be viewed as the return expected of a set of focused managers blended together to match the strategy biases of the subject manager (essentially, a blended peer group mean). Performance that is better than this mix is an indication of skill on the part of the manager.

A clear understanding of a manager's strategy biases will help a plan sponsor develop manager mixes that more effectively diversify manager biases. It will also enable them to more clearly discriminate between the luck of positioning and the skill of investing when evaluating a manager's past returns.

Return Series Available

BHSIs are available in monthly and daily return series. Please inquire for more information (inquiries@blueheronconsulting.com).

Restated Returns/Updates

We may periodically restate historical returns for a variety of reasons, including:

- Changes in management team. When there is a change in the management team we will review the circumstances and we may elect to delete the manager from the BHSI group beginning at the date of departure.
- Violation of our guidelines. We use managers with policies to hold no more than 10% cash. If a manager exceeds this limit, we will exclude their returns for the period in violation.
- Strategy Drift. We will exclude returns if we believe they are not indicative of the strategy.
- Errors. We will correct any errors we encounter and may restate returns. Major restatements will be announced.

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US EQUITY BHSI DESCRIPTIONS

Blue Heron Value

Value-Deep Value

Deep Value managers are extreme within the Value style. This group of managers seeks outsized returns from stocks that are not only undervalued, but also controversial and unloved, since that creates a greater pricing opportunity. This higher tolerance for fundamental risk is a differentiating feature of Deep Value managers, since they are often willing to invest earlier and with less fundamental confirmation than other value investors; companies may have depressed earnings and/or no dividend support, and financial quality may be poor. In addition to fundamental risk, this group is often willing to take on significant portfolio risk by concentrating bets in individual stocks and industries.

It is important to note that there are comparatively few true Deep Value managers today. While never a particularly large group due to the more extreme qualities of this strategy, there were more Deep Value managers in the early 1980s than there are at present.

Value-Dividend Yield

At the other end of the value spectrum from Deep Value managers, Dividend Yield managers are the most traditional, focusing on companies that are able to maintain or increase above-average yields. These investors believe that dividend yield is a stable value measure, since corporate managements and boards of directors make changes in dividend policy very deliberately. They also like the lower volatility of the strategy, as the higher yield component is usually a reliable source of return compared to capital appreciation. This strategy experienced difficulties in the late 1990s, when companies de-emphasized yield payments and funneled cash toward stock repurchases and reinvestment in their businesses. The strategy subsequently enjoyed a rebound as the overall market declined in 2000, 2001, and 2002. A greater focus on the quality of corporate earnings and more certain returns to shareholders has also helped this group in recent periods.

Value-Discounted Value

The Discounted Value strategy is the broadest within the Value style, consisting of managers who focus on companies that appear undervalued relative to trailing, normalized, or discounted forecast earnings. The original members of this strategy believed that P/Es were one of the best ways to value companies, and they often relied on academic research documenting the long-term value of such an approach. The strategy has broadened considerably as investors further developed what they consider to be the best measure of "value."

Value-Midcap Bias

Although Midcap Value managers differ in how they define "value," their first priority is the cheapness of a company's stock price. They may use any of the value strategies

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employed by their large cap counterparts, but have chosen to focus on relatively smaller companies, usually because they are less widely researched. Note that unlike their large cap counterparts, there tend to be fewer managers who place a high emphasis on dividend yield over other value measures; this is primarily because the companies are less mature in this cap sector. A Dividend Yield approach can also result in heavier sector concentrations than these managers find desirable.

Blue Heron Core

Core-Value Bias

Core-Value managers typically have diversified portfolios with a tilt toward Value, but the tilt is not sufficiently distinct from the overall market to put them in a broad Value style. A common reason for the moderate nature of their Value tilt is a portfolio structure that is diversified across most/all economic sectors. However, Core-Value managers generally place greater emphasis on business fundamentals than their Value counterparts, as they prefer better quality companies than the typical value manager is willing to pay for.

Core-Neutral

Core-Neutral managers create portfolios with market-like growth and valuation levels. Portfolio construction techniques are often the chief element creating market-like portfolio characteristics. They may also migrate in their preference for growth and value stocks having no consistent exposure to either group. Many underweight the largest cap names in the broad market compared to cap-weighted indexes.

Core-GARP

Growth-At-a-Reasonable-Price managers prefer companies with superior growth selling at modest valuation multiples. This strategy tends to be the least diversified of the Core approaches, and many portfolios are quite concentrated. They also tend to prefer stable companies that may have a "franchise" aspect to their businesses. The inherent belief is that these companies have relatively stable earnings that allow for long-term appreciation. They are close cousins to Consistent Growth managers in philosophy.

Core-Growth Bias

Core-Growth managers have portfolios with a tilt toward growth. Similar to Core-Value managers, the growth tilt is not sufficiently distinct from the overall market to put them in the broad growth style. A common reason for the moderate nature of the style tilt is diversification across most/all economic sectors. Core-Growth investors may also have a greater price orientation than their growth counterparts, as they cannot tolerate the higher price risk of companies the typical Growth investor would buy.

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Core-Midcap Bias

Core-Midcap managers do not espouse the strategies of growth or value investors' portfolios; as a result, their portfolio characteristics are close to market averages. A wide variety of strategies fall into this category. They may use any of the Core strategies employed by their large cap brethren, but have chosen to focus on relatively smaller companies, usually because they are less efficiently researched.

<u>Blue Heron Growth</u>

Growth-Consistent Growth

Consistent Growth managers believe that dominant companies with predictable earnings growth and demonstrated records of profitability will offer the best long-term returns. The implied belief is that other investors will place a significant premium on earnings predictability. Portfolio valuations are often at a premium to the market due to the generally superior financial quality of Consistent Growth companies. One way managers attempt to make money in this approach is by opportunistically purchasing stocks when multiples are lower relative to the company's history, assuming that the consistent earnings pattern will remain intact. Because of their selection criteria, Consistent Growth managers usually underweight cyclical companies. Instead, portfolios tend to be dominated by market leaders in consumer-oriented industries.

Growth-Earnings Momentum

Earnings Momentum managers prefer companies with earnings acceleration or high growth, which often have more volatile earnings. This class of manager believes that companies offering the best near-term earnings momentum provide the greatest magnitude of return within the growth universe. In contrast to Consistent Growth managers, they believe that investors are most interested in and will pay for earnings acceleration, as opposed to predictability. Some attempt to purchase companies in anticipation of earnings acceleration, while others prefer confirmation that an accelerating earnings trend is in place. Many do not stick to traditional growth sectors and may purchase companies in any industry over an economic cycle.

Growth-Midcap Bias

Midcap Growth managers seek companies with higher-than average growth on a trailing or forecast basis. They frequently pay premium multiples for superior growth, believing that future growth higher than investors currently expect will lead to even higher prices. Classic traits include use of higher quality companies; an emphasis on consumer, service, health care, and technology stocks; and lighter weightings in deep cyclicals and defensive stocks. Note that unlike their large cap counterparts, few undertake a consistent growth strategy; the less mature nature of Midcap companies makes this approach less feasible. The result is that this group tends to share many qualities with Earnings Momentum managers.

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