

Taking Stock

Second quarter 2009

In the spring rally, The Uninvestables blossom

Jennifer Boden,
quantitative analyst/
portfolio manager; Freda
Song Drechsler,
quantitative research
manager; David Kovacs,
chief investment officer,
quantitative strategies; and
Jeff Riggs, quantitative
analyst

For badly burned stock investors, the second-worst bear market ever came to an abrupt and welcome halt beginning on March 6. Until then, stock indexes had plummeted more than 50% from their peak in October 2007, erasing 12 years of gains and trillions of dollars in investors' wealth globally. (The only time the stock market had fallen harder was between August 1929 and June 1932, when the S&P 500 Index lost more than 83% of its value.)

The latest bear market was so relentlessly harsh that it sank share prices and market capitalizations to levels that were unprecedented in some cases. For instance, in November 2008, nearly one in 10 stocks traded below the value of their per-share holdings of cash -- a greater proportion than even in 1932, when the market was at its lowest point in history.

But the market suddenly reversed form in March, setting stocks on a sharply upward trajectory. And as the rally accelerated, it was abetted by hedge funds that were compelled to massively cover their short positions -- positions in stocks expected to perform poorly. From the intraday low of March 6 to May 8, in the course of 45 trading days, the S&P 500 Index rose 36.45%. Small stocks produced even more robust total returns. The Russell 2000 Index gained 46.26%, the Russell 2000 Growth Index went up 41.70%, and the Russell 2000 Value Index soared 50.98%.

Small and cheap prosper

In short, the smallest and cheapest -- and according to our quantitative model, the most fundamentally unsound -- stocks performed best. To us, the spectacular rally by small-cap stocks represented the investing equivalent of Newton's Third Law of Motion: any action produces an equal and opposite reaction. For example, one-quarter of the small-cap stocks in the Russell 2000 Value Index lost 65.5% or more in the 12 months prior to the rally, then rebounded with a vengeance.

Indeed, almost without exception, the lower a small-cap stock's price, the smaller the market capitalization, and the bigger the loss over the previous 12 months, the better that stock performed in the topsy-turvy market from March to May. Across the board, the small-cap stocks ranked by our quantitative model in the bottom

quartile in those three criteria -- price, market capitalization, and performance -- did best. And in almost uniformly descending order, the returns of the stocks in the three higher quartiles performed progressively worse. In other words, the stocks ranked in the third-best quartile did better than the stocks ranked in the second-best quartile, and the stocks in the second-best quartile outperformed the stocks in the top quartile. In a sense, less really did prove to be more in this rally.

As welcome as the rally was, it presented a new set of problems for investors, particularly for institutional investors who can only hold small-cap stocks that meet certain thresholds of price and market capitalization. In the wake of the bear market, small stocks priced at \$1 or less accounted for about 25% of the small-cap benchmarks' weightings, compared with the historical average of 5%. And about 25% of all small-cap stocks had market capitalizations that had been depressed to under \$110 million, a decline of more than 60% since September 2007.

Penny stocks proliferate

In essence, there were an uncommon number of penny stocks, and they rose as much as 965.80% (no, this is not a typographical error) in those 45 trading days. By and large, they were stocks that many investment managers, including us, were unable to own because their prices or their market capitalizations or both were too low. *Pensions & Investments* calls such stocks "The Uninvestables." In our case, client mandates for our quantitative portfolios prohibit us from even considering stocks priced at less than \$1 or with market capitalizations less than \$100 million. Unfortunately, the reality in early March was that more than 25% of the stocks in the Russell 2000 Value Index, for one, had market capitalizations under \$100 million and thus were off limits to the Turner Quantitative Small Cap Value Equity portfolios.

What's more, the outperformance of small-cap stocks in the spring rally generally had little to do with fundamentals. As we see it, a rational investor -- and certainly, our quantitative model -- doesn't base investment decisions on factors such as absolute stock price, the smallest market capitalization, or the biggest percentage decline in price over the previous 12 months. But small-cap stocks with those characteristics were precisely the ones producing the best results from March to May.

For instance, in the Russell Microcap Growth Index, the stocks ranked in the fourth, or lowest, quartile for the factor of market capitalization -- stocks with market capitalizations under \$26.5 million -- returned 93.49% from March 6 to May 8 (*see table, page 3*). Stocks in the third quartile, with capitalizations of \$26.6 million

In the spring rally, The Uninvestables blossom / 3

As the market surged strongly from March to May, the lower that small-cap stocks were ranked in our quantitative model, the better they tended to perform

Russell Microcap Growth Index stocks' total returns March 6-May 8, 2009

	<i>Factor: market capitalization</i>	<i>Factor: price</i>	<i>Factor: price momentum</i>	<i>Factor: price/book ratio</i>	<i>Factor: beta *</i>
Quartile 4 (lowest rank)	93.49%	84.42%	92.14%	108.34%	68.93%
Quartile 3	61.31	76.44	59.83	56.15	39.45
Quartile 2	56.26	45.95	42.35	44.85	41.78
Quartile 1 (highest rank)	32.27	26.20	31.53	28.90	25.30

Russell 2000 Growth Index stocks' total returns March 6-May 8, 2009

	<i>Factor: market capitalization</i>	<i>Factor: price</i>	<i>Factor: price momentum</i>	<i>Factor: price/book ratio</i>	<i>Factor: beta *</i>
Quartile 4 (lowest rank)	95.18%	100.58%	100.46%	103.27%	78.79%
Quartile 3	63.44	60.02	57.13	54.56	51.90
Quartile 2	56.20	45.50	39.19	42.40	40.12
Quartile 1 (highest rank)	29.60	27.53	24.40	24.04	24.93

Russell 2000 Value Index stocks' total returns March 6-May 8, 2009

	<i>Factor: market capitalization</i>	<i>Factor: price</i>	<i>Factor: price momentum</i>	<i>Factor: price/book ratio</i>	<i>Factor: beta *</i>
Quartile 4 (lowest rank)	167.03%	147.69%	147.66%	134.34%	119.01%
Quartile 3	80.53	77.51	72.44	62.73	68.24
Quartile 2	59.04	50.47	46.47	41.98	48.54
Quartile 1 (highest rank)	34.78	29.49	29.67	27.49	25.49

* The lowest ranked stocks have the highest betas.

to \$59.5 million, gained 61.31%. Stocks in the second quartile, with market capitalizations of \$59.5 million to \$130.2 million, returned 56.26%. And stocks in the first quartile, with market capitalizations of \$130.3 million to \$1.2 billion, advanced “only” 32.27%, or 61.22 percentage points less than the fourth-quartile stocks did.

Results of a lifetime?

In our view, the stocks of the Russell Microcap Growth Index and other small-cap indexes in that fourth quartile generated two-month returns so extraordinary that they are unlikely to be duplicated for a long time to come. Some of these returns were of a magnitude normally attained over two *decades* or more, not two *months*. By way of illustration, here are the best-performing stocks in the fourth quartile of market capitalization -- again, stocks with the smallest

capitalizations -- during the March-May rally, categorized according to sector:

- Vanda Pharmaceuticals, up 965.80% in the health-care sector;
- LodgeNet Interactive, up 683.47% in the consumer-discretionary sector;
- Avanex, 565.46% in the technology sector;
- Edge Petroleum, 401.63% in the energy sector;
- SL Industries, 261.33% in the producer-durables sector;
- Uranium Energy, 260.77% in the materials/processing sector;
- Physicians Formula Holdings, 253.01% in the consumer-staples sector;
- Grubb & Ellis, 247.07% in the financial-services sector; and
- Xfone, 54.83% in the utilities/communication sector.

Or take another factor in our quantitative model, the value-oriented metric of price/book ratio. In the Russell 2000 Growth Index, the stocks in the fourth quartile with the lowest price/book ratios -- ratios ranging from 0.1 to 0.7 -- outperformed stocks in the first quartile by 79.23 percentage points (*see table, page 3*). Specifically, the stocks ranked in the fourth quartile for price/book ratio returned 103.27%; stocks in the third quartile, 54.56%; stocks in the second quartile, 42.40%; and stocks in the first quartile, 24.04%.

The last are first

Or consider the quantitative factor of price momentum. In the Russell 2000 Value Index, stocks that ranked lowest in price momentum -- the stocks that suffered the biggest losses in the previous 12 months -- subsequently did an about-face and produced the biggest gains from March 6 to May 8 (*see table, page 3*). The Russell 2000 Value Index stocks ranked in the fourth quartile had recorded 12-month losses ranging from 65.5% to 99.2%. But, incredibly, they returned an average of 147.66% from March 6 to May 8. The stocks in the third quartile, with losses ranging from 41.5% to 65.3% previously, gained 72.44%. Stocks in the second quartile, with losses ranging from 17.9% to 41.4% previously, were up 46.47%. And stocks in the first quartile, with returns ranging from a loss of 17.8% to a gain of 171.9%, returned 29.67%.

The difference in performance between the stocks ranked by our quantitative model as lowest and highest in the factors of market capitalization, price, price momentum, price/book ratio, and beta was most pronounced in the Russell 2000 Value Index. For the market capitalization factor, the lowest-ranked quartile outperformed the top-ranked quartile by 132.25 percentage points. For the price factor, the lowest-ranked quartile beat the top-ranked quartile by 118.20 percentage points. For the price momentum factor, the differential was 117.99 percentage points. For the price/book ratio factor, the performance advantage was 106.85 percentage points. And for the beta factor, the edge was 93.52 percentage points.

In our analysis, this rally was an atypical, perverse phenomenon, a statistical fat tail, an investing anomaly. We doubt that any time soon we will encounter a stock-market rally that so lavishly rewards The Uninvestables -- stocks with prices and market capitalizations that are so low that we and other institutional investors can't touch them. Since May 8, the market has in fact reverted to more typical patterns of performance. Large-cap, mid-cap, and the more sizable small-cap stocks have improved their relative performance versus the very smallest stocks. We think stocks with more to offer than exceptionally low prices and market capitalizations -- namely, stocks with good fundamentals and high rankings by our quantitative model in factors that have proven predictive of outperformance -- should do well in this post-bear-market phase over time, as has typically been the case.

The views expressed represent the opinions of Turner Investment Partners as of the date indicated and may change. They are not intended as a forecast, a guarantee of future results, investment recommendations, or an offer to buy or sell any securities. Opinions about individual securities mentioned may change, and there can be no guarantee that Turner will select and hold any particular security for its client portfolios. Earnings growth may not result in an increase in share price. Past performance is no guarantee of future results.

Turner Investment Partners, founded in 1990 and based in Berwyn, Pennsylvania, is an investment firm that manages more than \$14 billion in stocks in separately managed accounts and mutual funds for institutions and individuals, as of March 31, 2009.

As of May 31, 2009, Turner held in client accounts 244,980 shares of Vanda Pharmaceuticals. Turner held no shares of LodgeNet Interactive, Avanex, Edge Petroleum, SL Industries, Uranium Energy, Physicians Formula Holdings, Grubb & Ellis, and Xfone.

In the spring rally, The Uninvestables blossom / 6

You cannot invest in an index. An index does not have an investment adviser and does not pay commissions, expenses, or taxes. If an index had these expenses, performance would be lower.

The Russell Microcap Growth Index measures the performance of those Russell Microcap companies with higher price/book ratios and higher forecasted growth values. The Russell 2000 Growth Index measures the performance of those Russell 2000 companies with higher price/book ratios and higher forecasted growth values. The Russell 2000 Value Index measures the performance of those Russell 2000 companies with lower price/book ratios and lower forecasted growth values.

Price/book ratio compares a stock's market value to the value of total assets less total liabilities (book value).

Beta is a measure of a portfolio's volatility relative to its benchmark.

Price momentum is the movement of a stock price over the past year as compared to a market index.