Russell Research / Ranks and Commentary

CONNOR, CLARK
PRODUCT: CANADIAN EQUITY Q CORE FUND

ASSET CLASS	GEOGRAPHPIC EMPHASIS	STYLE	SUBSTYLE
Equity	Canada	Market Oriented	Quantitative

ACTIVITY DATE	LOCATION	ACTIVITY TYPE	PURPOSE
19Oct2010	Vancouver, BC, Canada	Research - Manager Office	Product Review

OVERALL EVALUATION

1 2 3 **4**
Hire

We recommend that clients consider this manager for new placements and additional cash flow where appropriate.

Target Excess Return: 100 bp
Target Tracking Error: 250 bp
Time Period: > 4 years
Russell Assigned BenchMark: S&P/TSX COMP

Expected Performance Pattern

The product's market-oriented portfolio structure dictates that it should perform well in a variety of market environments. We expect the product to add at least 100 basis points of value relative to the S&P/TSX Composite Index over rolling four-year periods with associated tracking error of approximately 250 basis points. Modifications to the model should help the portfolio weather extreme environments in Canada better than it has in the past.

Manager Update

The purpose of our meeting in Vancouver with Connor, Clark & Lunn Investment Management (CC&L) was to discuss the firm and the Canadian Q-Products. We discussed enhancements to CC&L's model and process, their research agenda, an analysis that Martin Gerber has done on style diversification in Canada compared to the U.S. and the firm's outlook for quantitative investing. We met the three key members of CC&L's quantitative team, Martin Gerber, Steven Huang and Dion Roseman, and have reaffirmed our view that CC&L's quantitative approach is superior to most other quantitative firms in Canada in terms of their insight, depth and breadth of research and quantitative sophistication. We are reaffirming the "Hire-4" ranks on their Q-Core, Q-Growth and Q-Value products.

They have made a number of enhancements to their model and process, which we believe will make the model more adaptable to changing environments. They recognized that there are extreme periods in the market that are dominated by macro factors or a specific style and have made modifications to the model, which should help them navigate through those challenging periods more effectively. Most of the enhancements are classified as forecast improvements but

LOW ① ② ③ ④ ⑤ HIGH

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there have also been modifications to portfolio construction and implementation.

CC&L has a robust research agenda for 2011 with at least a couple of the topics focused on how to improve performance in volatile environments. We remain confident that their research philosophy focused on investment fundamentals and unique insights differentiates them from most other Canadian quantitative firms and will keep them ahead of the curve in terms of research and testing.

The team at CC&L is stable and we have confidence in all the key professionals although we consider Martin Gerber most critical since he was instrumental in building the models and continues to drive the research agenda.

Performance

After struggling in the first half of 2009 in a challenging active management environment, the CC&L Q-Core product has added value in all but one quarter since then. For the one-year period ending September 30, 2010, the portfolio returned 14.1%, which was roughly 250 basis points ahead of the S&P/TSX Composite return of 11.6%. Over the same period, the portfolio was ahead of the median market-oriented manager by 355 basis points. The second and third quarters of 2010 were difficult for active managers generally but the CC&L Q-Core product only lagged the benchmark slightly in the third quarter. They believe that the model enhancements in the last year are helping them weather more challenging environments. Over the longer-term 4- and 5-year annualized periods, the portfolio was roughly 50 and 10 basis points ahead of the benchmark, respectively. Compared to the median market-oriented manager, CC&L's Q-Core portfolio was ahead by roughly 80 and 10 basis points, respectively over the same 4- and 5 -year periods.

CC&L's Q-Value fund has performed well in most of 2009 and into 2010 but has struggled in the second and third quarters of 2010 as the value style of investing was not rewarded. However, for the one-year period ending September 30, 2010, Q-Value has returned 12.6%, which was roughly 100 basis points ahead of the S&P/TSX Composite and 80 basis points ahead of the median value manager return. Over the past 4- and 5-years, annualized returns for the periods ending September 30, 2010 are roughly 60 and 40 basis points ahead of the benchmark, respectively. Relative to the median value manager, their returns are 40 basis points ahead over the same 4- and 5-year annualized periods. The product struggled relative to the benchmark when the value style was out of favour but they did hold up better than peers.

CC&L's Q-Growth product lagged the benchmark in 2009 but has performed well in most quarters since then, particularly relative to the median growth manager. The Q-Growth portfolio returned 14.1% for the one-year period ending September 30, 2010, which was 250 basis points ahead of the S&P/TSX Composite return and 410 basis points ahead of the median growth manager return. Over the longer-term, value added relative to the benchmark is mixed with the 4-year return roughly 15 basis points head and the 5-year return roughly 15 basis points behind. Poor performance in 2006 is weighing down the 5-year numbers. Relative to the median growth manager, the portfolio was ahead by roughly 65 basis points over the 4-year annualized periods ending September 30, 2010 and roughly 5 basis points over the 5-year period ending September 30, 2010.

Martin believes that the opportunity set for active managers in Canada has improved notably in the last couple of quarters and the drop in assets under management in equities, due to flows moving into ETFs and Index funds in the last few years, and the resulting improvement in the competitive landscape will make it easier for active managers, including quantitative firms, to add value.

LOW 1 2 3 4 5 HIGH

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Investment Staff ① ② ③ ④ ❺

Dion Roseman has been portfolio manager for CC&L's Canadian Equity Q-Products since May 2008 when Bill Tilford resigned from the firm. Chris Archbold is still Dion's back-up; however, they manage the portfolios more as a team than when Bill Tilford was the lead. We are confident that they possess solid quantitative skills.

Martin Gerber, the team leader for the Q-Team, was instrumental in the initial development of the Q-Products and he remains focused on them, which we view positively since we have a high conviction level in his abilities. If Martin were to leave the firm, we would reconsider this rank since we view him as critical to the process.

Resources continue to be allocated to the quantitative team, which we view favorably. Steven Huang and Tate Haggins primarily focus on research. Steven leads the day-to-day research effort and we have a positive view of his abilities. The firm added support staff in 2008 and now has four research analysts, four data analysts, four systems analysts, and two traders. We have a high opinion of the quantitative team overall and believe the resources dedicated to the quantitative products are high relative to peers.

Organizational Environment ① ② ③ ❹ ⑤

CC&L is one of the largest domestic investment counselors and firm assets under management were approximately $21 billion at September 30, 2010. Firm-level AUM have increased in the last year but remain below the peak of $23.2 billion at the end of 2007. They continue to have a solid revenue base, the majority of which comes from their institutional business line. Assets have increased in the Q-Products (Canadian and U.S.) in the last year to $5.3 billion as of September, 2010, up from $4.8 billion a year earlier. We have no concerns about the financial viability of the firm.

There have not been any significant departures in the team since Bill Tilford left in May 2008. There is a reasonably low likelihood of disruptive staff turnover that will impact this product. In general, we view positively the change to internally financed stock ownership from the old scheme where individuals had to secure loans from external sources. This move increased CC&L's ability to attract and retain high-quality younger professionals because the terms of share ownership will be less onerous.

Security Selection ① ② ③ ④ ❺

The Q-Core product's selection methodology is robust and diversified, including measures of Value, Momentum, Profitability, Financial Strength and Stability, and Quality, all of which have proven effective at adding value over time in the Canadian equity market. Over the years, CC&L have continuously improved the model by adding new factors or modifying existing factors and are usually ahead of peer quantitative managers in terms of innovation, which we view positively.

The Q-Core portfolio is market-oriented, with incidental bets against any key factor intentionally avoided. As a result, the portfolio is intended to outperform during periods when either the value or growth investment style is in favor. CC&L has been more forthcoming about their models compared to other quantitative-oriented firms; in Q-Core, the target model exposures are roughly equally-weighted between Momentum and Value, which are the primary sources of alpha; Quality has a lesser weight, which makes sense given the magnitude of the payoff to Quality tends to lag that to Growth and Value factors. They avoid over-fitting the model and we like this intuitive approach to model construction.

LOW ① ② ③ ④ ⑤ HIGH

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Research 1 2 3 4 **5**

Martin Gerber is responsible for setting the research agenda for the Q-Products (while Dion Roseman and Chris Archbold are the day-to-day Portfolio Managers for the funds); we view this positively since we have a high opinion of Martin. In addition, the team now has two full-time Portfolio Researchers, Steven Huang and Tate Haggins, who are supported by four research analysts and four data analysts. Therefore, we view the level of resources as more than sufficient. We also feel that the quality of research is well above average compared to peers.

Asset Allocation 1 2 3 4 5

This component is unranked as CC&L's Q-Products are intended to be managed as fully-invested portfolios.

Sell Decision 1 2 3 **4** 5

The product's sell discipline is purely a function of the optimization process and they have been trading on a daily basis since 2006. Furthermore, the purely quantitative focus of this product allows for complete emotional detachment, which allows CC&L an edge in their sell discipline over many fundamentally-focused managers.

Portfolio Construction 1 2 3 4 **5**

The goal of CC&L's quadratic optimizer is to structure the portfolio to have better-than-market value, momentum and quality characteristics while constraining the portfolio to having market-like risk characteristics (Profitability, Financial Strength and Stability). As a result, CC&L's Q-Core portfolio is not simply a combination of their Q-Value and Q-Growth portfolios. Their portfolio construction methodology is interesting and unique (at least in Canada) because return expectations of individual stocks are not explicitly considered.

The inclusion of a sector model to this product allows the portfolio to be overweight sectors that CC&L believes have a high probability of outperforming in the short-term. We are confident that this diversification of excess return drivers is a logical and positive extension of CC&L's processes.

CC&L has built a proprietary factor-based risk model; this new model is much simpler as it includes only six factors and it is also much better at forecasting risk. We view positively that they give as much thought to alpha as they do to risk.

Implementation 1 2 3 **4** 5

We believe the small size of CC&L's Q-Team should enable the results of the optimization process to be implemented quickly and efficiently. AUM is not an issue at this time as the total assets in the Canadian Equity Q-Products was $4.7 billion at September 30, 2010 and they estimate capacity of $8.0 billion.

A previous concern we had with CC&L is that they did not optimize and rebalance the portfolio often enough to efficiently capture new information; however, they moved to daily trading in 2006. As well, they continue to focus some of their research on enhancements to portfolio implementation, which we view positively.

LOW 1 2 3 4 5 HIGH

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