

# RussellResearch

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## Connor, Clark & Lunn Investment Management Limited

### CANADIAN EQUITY Q CORE FUND

Equity | Canada | Market Oriented | Quantitative

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# Connor, Clark & Lunn Investment Management Limited

PRODUCT: CANADIAN EQUITY Q CORE FUND

**ASSET CLASS**  
Equity

**GEOGRAPHIC EMPHASIS**  
Canada

**STYLE**  
Market Oriented

**SUBSTYLE**  
Quantitative

## OVERALL EVALUATION



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

**Updated By:** Phil Chen  
**Target Excess Return:** 100 to + bp  
**Target Tracking Error:** 200 to 300 bp  
**Time Period:** > 4 years  
**Russell-Assigned Benchmark:** S&P/TSX Composite Index

## DISCUSSION

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

We believe that the Connor, Clark & Lunn (CC&L) Q-Core product will be able to add at least 100 basis points of value per year, relative to the S&P/TSX Composite Index, over rolling four-year periods. The portfolio is constructed in a manner consistent with tracking error of approximately 200 to 300 basis points. This product's market-oriented portfolio structure dictates that it should perform well in a variety of market environments. The key watch point for Russell is any potential change to CC&L's Q processes as they grow assets in these quantitative Q-Strategies.

## INVESTMENT STAFF

At the end of May 2008, Bill Tilford resigned from CC&L. Officially, Dion Roseman has replaced Bill as the portfolio manager for CC&L's Canadian Equity Q-Products with Chris Archbold as his 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 about his abilities.



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Resources continue to be allocated to the quantitative team which we view favourably. Steve Huang and Tate Haggis primarily focus on research. Steve leads the day-to-day research effort; we met him in 2008 and our initial impression is positive. The firm continues to add support staff and now has four research analysts, four data analysts, four systems analysts plus three traders. We have a high opinion of the quantitative team overall.

**ORGANIZATIONAL ENVIRONMENT** ① ② ③ ④ ⑤

CC&L is one of the largest domestic investment counselors and firm assets under management were approximately \$17.4 billion at December 31, 2008. Although AUM has fallen since the end of 2007 from \$23.2 billion, they continue to have a solid revenue base, the majority of which comes from its institutional business line. Most of the decline in AUM on the equity side has been in the CC&L Q products, which had dropped from \$6.3 billion to \$3.9 billion in the past year. Although AUM at the firm level has decreased significantly, we have no concerns about the viability of the company since AUM is still high.

Although Bill Tilford was important in the developmental stages of the Q-Products, his role had evolved to that of overseeing the portfolio on a day-to-day basis. He has accepted a senior position at CPPIB which has increased challenges and responsibilities; we do not view his departure in May 2008 as indicative of any organizational issues.

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 will increase 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 ⑤

The Q-Core product's selection methodology is robust and diversified, including measures of Value (e.g., P/E, P/CF), Momentum (e.g., earnings and revenue growth, relative strength, investor sentiment changes), Profitability (e.g., ROE, ROA), Financial Strength (e.g., debt/cash flow) and Stability (e.g., EPS and price volatility), all of which have proven effective at adding value over time in the Canadian equity market. As well, CC&L added a new factor, Accruals (e.g., Working Capital and Non-Cash Operating Assets), into the model during 2006 then expanded the factor by adding capital deployment and analyst forecast earnings growth indicators and renamed it Quality. The Quality factor identifies companies with better quality earnings relative to industry peers. 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 favour. CC&L has been more forthcoming about their models recently; in Q-Core, the target model exposures are roughly equally-weighted between Quality, Momentum and Value. They avoid over-fitting the model and we like this intuitive approach to model construction.



**CONNOR, CLARK & LUNN INVESTMENT MANAGEMENT LIMITED****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 Haggis who are supported by four research analysts and four data analysts. Therefore, we view the level of resources as more than sufficient. Despite having to compete with larger quantitative investment management firms that possess greater resources, we feel that CC&L is adequately staffed at the current time and 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.

In July 2006, CC&L introduced a sector model to Q-Core; nevertheless, 90% of the exposures are still less than 1.5% (i.e. the constraint when there was no sector model) with the maximum bets limited to +/-3% (but this was rarely approached in their 10-year back test). Furthermore, portfolios are constrained to +/-4% at the GIC level. We are confident that this diversification of excess return drivers is a logical and positive extension of CC&L's process.

CC&L has built a proprietary factor-based risk model; this new model is much simpler as it only 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 \$3.3 billion at December 31, 2008 and they estimate their capacity at \$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 have completed research and they moved to daily trading in late November 2006. As well, they continue to focus some of their research on more enhancements to portfolio implementation which we view positively.



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The Q-Core product has about \$1.9 billion invested in it, so AUM will not be a concern to liquidity for a while, especially with the portfolio maintaining a market-like capitalization profile.

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**Connor, Clark & Lunn Investment Management Limited****PRODUCTS REVIEWED**

<b>PRODUCT</b>	<b>ASSET CLASS</b>	<b>GEOGRAPHIC EMPHASIS</b>	<b>STYLE</b>	<b>SUBSTYLE</b>
Canadian Equity Q 120/20	Equity	Canada	Market Oriented	Quantitative
Canadian Equity Q Core Fund	Equity	Canada	Market Oriented	Quantitative
Canadian Equity Q Growth Fund	Equity	Canada	Growth	Quantitative
Canadian Equity Q Value Fund	Equity	Canada	Value	Quantitative

**MANAGER UPDATE**

ON NOVEMBER 12, 2008, KATHLEEN WYLIE AND PHIL CHEN MET WITH MARTIN GERBER AND MARKETING STAFF FROM CONNOR, CLARK & LUNN INVESTMENT MANAGEMENT (CC&L) FOR OUR REGULAR SEMI-ANNUAL RESEARCH REVIEW ON THEIR CANADIAN EQUITY Q-PRODUCTS. AS ALWAYS, MARTIN WAS IMPRESSIVE DURING HIS DISCUSSION OF THEIR RESEARCH AGENDA AND WE CONTINUE TO HAVE HIGH CONVICTION IN THE QUANTITATIVE CAPABILITIES OF CC&L. Q-VALUE HAS RECENTLY WON ITS FIRST CLIENT MANDATE SO WE VIEW POSITIVELY THAT THE MARKETPLACE HAS EMBRACED QUANTITATIVE VALUE INVESTING. WE ARE MAINTAINING OUR "4 – HIRE" RANKS ON CC&L'S Q-CORE, Q-GROWTH AND Q-VALUE CANADIAN EQUITY PRODUCTS.

**ASSETS UNDER MANAGEMENT**

WHILE AUM DECLINED DURING 2008, THIS WAS DUE PRIMARILY TO MARKET ACTION AND WE HAVE NO CONCERNS ABOUT CC&L GIVEN THAT THEY WERE MANAGING A TOTAL OF ABOUT \$17.4 BILLION AT DECEMBER 31, 2008. WITH ABOUT \$3.9 BILLION ACROSS THE ENTIRE SUITE OF Q-PRODUCTS, INCLUDING OVER \$3.3 BILLION IN CANADIAN EQUITY Q-PRODUCTS, THERE ARE NO ISSUES ABOUT THE VIABILITY OF THESE MANDATES.

**MODEL UPGRADES AND RESEARCH AGENDA**

GIVEN THAT INCOME TRUSTS WILL BE REVERTING TO COMMON EQUITIES, CC&L COMPLETED RESEARCH AND HAS INCORPORATED FOUR OF THEIR TRUST SECTOR MODELS INTO EQUITY SECTOR MODELS; HOWEVER, THEY ARE KEEPING THEIR REITS MODEL. WHILE THIS REDUCES THE NUMBER INDUSTRIES IN THEIR MODEL DOWN TO ONLY 19, THEY HAVE ALREADY COMPLETED RESEARCH AND EXPECT TO INCREASE THE NUMBER OF SECTORS IN EARLY 2009. AS WELL, THEY ARE ALREADY USING THEIR U.S. MODEL TO PROVIDE ADDITIONAL INDUSTRY INSIGHTS INTO THEIR CANADIAN MODEL. TRANSACTION COST FORECASTS HAVE IMPROVED WHICH MEANS THAT THEY ARE NOW DIFFERENTIATING STOCKS BY HOW QUICKLY THEY SHOULD BE TRADED; AS A RESULT, THE NEXT STEP IS THAT THEY ARE BUILDING A MULTI-PERIOD OPTIMIZER AND MARTIN EXPECTS THIS TO BE IMPLEMENTED LATER IN 2009.

**ALL PERFORMANCE FIGURES REFERENCE DECEMBER 31, 2008 AS THE END DATE.**

THE S&P/TSX COMPOSITE INDEX RETURNED ABOUT -33.0% DURING 2008. Q-CORE WAS AHEAD OF THE INDEX BY ABOUT 140 BASIS POINTS AND ALSO 70 BASIS POINTS AHEAD OF THE MEDIAN MARKET-ORIENTED

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MANAGER. Q-GROWTH WAS AHEAD OF THE INDEX BY ABOUT 30 BASIS POINTS AND ALSO 150 BASIS POINTS AHEAD OF THE MEDIAN GROWTH MANAGER. Q-VALUE WAS AHEAD OF INDEX BY ABOUT 120 BASIS POINTS AND THE ONLY QUARTER THAT IT LAGGED THE BENCHMARK WAS IN Q4; HOWEVER, Q-VALUE TRAILED THE MEDIAN MANAGER SIGNIFICANTLY IN BOTH Q3 AND Q4 WHICH RESULTED IN THE PRODUCT BEING 200 BASIS POINTS BEHIND THE MEDIAN VALUE MANAGER FOR THE PAST YEAR. MARTIN WAS VERY AWARE THAT Q-VALUE TRAILED THE MEDIAN BUT STRESSED THAT THEY ARE MORE DILIGENT ABOUT MANAGING RISK EXPOSURES WHERE AS VALUE PEERS WILL OFTEN HAVE MUCH LARGER BETS, ESPECIALLY AT THE SECTOR LEVEL. INDEED, WE VIEW POSITIVELY THAT Q-VALUE HAS DELIVERED A MORE CONSISTENT STREAM OF VALUE ADDED RETURNS.

OVER THE FOUR-YEAR ANNUALIZED PERIOD, THE BENCHMARK RETURNED ABOUT 1.7%. Q-CORE WAS ABOUT 10 BASIS POINTS AHEAD OF THE BENCHMARK BUT BEHIND THE MEDIAN MARKET-ORIENTED MANAGER BY ABOUT 80 BASIS POINTS. BOTH STYLE PRODUCTS CONTINUE TO PERFORM WELL OVER THE LONG TERM. Q-GROWTH WAS AHEAD OF THE INDEX BY ABOUT 220 BASIS POINTS AND ALSO THE MEDIAN GROWTH MANAGER BY ABOUT 230 BASIS POINTS. SIMILARLY, Q-VALUE WAS AHEAD OF THE INDEX BY ABOUT 70 BASIS POINTS AND ALSO THE MEDIAN VALUE MANAGER BY ABOUT 80 BASIS POINTS.

If you have any questions regarding this manager or these products, please contact your client executive.

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