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RussellResearch

Highstreet Asset Management Inc.

CANADIAN EQUITY

Equity | Canada | Market Oriented | Quantitative

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Russell Investments

Opinion

Highstreet Asset Management Inc.

PRODUCT: CANADIAN EQUITY

ASSET CLASS	GEOGRAPHIC EMPHASIS	STYLE	SUBSTYLE
Equity	Canada	Market Oriented	Quantitative

OVERALL EVALUATION

① ② ③ 4 Hire

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

Updated By: Kathleen Wylie
Target Excess Return: 100 to + bp
Target Tracking Error: 300 to 500 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 expect this product to outperform the S&P/TSX Composite Index by greater than 100 basis points basis points over longer annualized time periods (i.e., in excess of four years). We expect historical tracking error levels to be between 300 and 500 basis points going forward due to the relatively concentrated nature of Highstreet's market-oriented portfolio.

The product's strengths include the quality of its investment staff, a disciplined security selection process and sell discipline. We believe Highstreet's portfolio will match or exceed the broader market performance in most market environments considering their focus on both value and growth characteristics.

INVESTMENT STAFF ① ② ③ 4 ⑤

Effective January 7, 2008, Shaun Arnold has taken over as Chief Investment Officer from Jeff Brown, who is now responsible for development and leadership of the US equity portfolio teams. In addition to continuing focus on the core Canadian equity mandates, Shaun has joint leadership of Highstreet's investment team alongside Rob Jackson who is now the Chief Risk Officer. As expected, Doug Crocker retired from Highstreet as Chief Risk Officer effective September 30, 2008. Shaun has five investment professionals who report directly to him including Jeff although Shaun stressed that it is only "on paper." We are disappointed that Jeff is no longer directly involved in the Canadian equity products but we have confidence in Shaun's investment and leadership abilities.

We view positively that Highstreet has increased the investment team over the years to 14 professionals. Among the new hires was a trader last year as well as a dedicated client-service professional, which should help to allow the portfolio managers to focus more on investing and which we view positively.

LOW ① ② ③ ④ ⑤ HIGH

We had some concerns about the introduction of new products by AGF during the year and the allocation of time to development and management of those products by Highstreet team members but view positively that two of the three products have been shut down.

ORGANIZATIONAL ENVIRONMENT ① ② ③ ❹ ⑤

In 1998, Highstreet was formed by three former employees of London Life Investment Management: Jeff Brown, Rob Badun (LLIM's former President) and Doug Crocker (Highstreet's head of Fixed Income). In May, 2005, Highstreet bought back the remaining 35% that was owned by Brascan Financial, which was a founding partner. As a result, the firm was 100% owned by 11 shareholders who each owned between 7% and 15% of the firm.

In November 2006, AGF Management Limited purchased 80% of Highstreet with the remaining 20% split roughly evenly between 10 Highstreet partners. Rob Badun, who was the CEO of Highstreet has sold all of his Highstreet shares and joined AGF's executive team as President of AGF Private Investment Management but has since become head of the portfolio management teams at AGF so he no longer has day-to-day contact with Highstreet.

The AGF transaction was a combination of cash and the issuance of AGF non-voting class B shares and will be paid out over a 3-year period. There are financial penalties for the partners or key investment personnel who leave Highstreet before the 3-year period, which we viewed positively although it was a surprise to learn that Doug Crocker was exempt from those penalties when he retired early. It is also worth nothing that there is a penalty to AGF if they terminate Highstreet personnel within the 3-year period.

Despite the lock-ups, we had some concerns that ownership was highly concentrated with only five investment professionals sharing about a 10% ownership stake. Highstreet's ownership remains at 20% but is now broader with 19 shareholders; we need to confirm how many investment professionals are shareholders now. Ideally, Highstreet would like their ownership to increase to 25% with all staff participating. The long term plan is for ownership to replace the current profit-sharing plan but we will need to monitor this to ensure that the overall compensation of the key investment professionals is competitive.

The Highstreet team is stable, managing roughly $4.3 billion currently in a variety of equity and fixed income mandates. AUM is down from $5.4 billion at the end of 2007 but the market has been mainly responsible for the decline with Highstreet having gained more clients than they lost during 2008. We continue to believe that the history of the employees working together at London Life, and the reasonably diversified nature of Highstreet's revenue base makes the team more stable than most other organizations. However, we are monitoring closely the impact that AGF is now having on the firm. AGF introduced three new equity products in the past year (although as noted above two products have been shut down) and AGF may have impacted the decision to change the reporting structure.

SECURITY SELECTION ① ② ③ ❹ ⑤

Through their screening of the multiple data sources, Highstreet targets those growth and value and quality factors that have historically been successful determinants of relative outperformance in the Canadian equity market. Specifically, Highstreet targets better historical earnings growth, lower Price/Earnings and higher reinvestment rates than the S&P/TSX Composite. As well, positive market-relative price momentum is considered, although it is not formally part of Highstreet's model.

LOW ① ② ③ ④ ⑤ HIGH

Highstreet does not adjust their model for industry-specific differences. We believe this is a slight shortcoming of their screening process, although we are confident that Highstreet considers other measures of value and growth than what is included in their model.

RESEARCH ① ② ❸ ④ ⑤

Generally, Highstreet's process is 80% quantitative and 20% fundamental. For their quantitative screening, they rely on multiple sources rather than just CPMS as they did in the past.

We continue to believe that Highstreet has a deeper understanding of CPMS that allows them to use it more effectively than other managers and gives them a competitive advantage. Still, we view positively that they are de-emphasizing the use of CPMS in their process.

In June 2005, the firm hired John McNair to work on quantitative research including testing, making recommendations and minor changes to the model. During our meetings, John has not shown much insight so we were not that impressed with his research abilities compared to other quantitative researchers. Their practice is to only review existing models every 3 years and we have observed in the past year that their focus has been more on the development of new products for AGF rather than on maintenance of existing products, which we view negatively. Compared to other higher ranked quantitative shops, we believe Highstreet is average in terms of their quantitative development and model testing.

It was our understanding that in the past, Fred was focused on the "traditional" research (which was previously referred to as "fundamental" research) for the roughly 75 companies that are short-listed from their screens to ensure that the rankings reflect the reality of the company. Fred is now more focused on portfolio management with Steve Duench hired in 2007 to work with John. Robert Yan is also now a member of the research team, replacing Brian Mellen who focuses on data management but is currently on disability leave. We should meet other members of the research team besides John to gain a better understanding of their responsibilities and abilities.

ASSET ALLOCATION ① ② ③ ④ ⑤

Highstreet believes in maintaining fully invested portfolios at all times, which we view favourably. Highstreet will equitize any residual short-term cash. As a result, this category is unranked.

SELL DECISION ① ② ③ ④ ❺

Highstreet's sell discipline is very responsive relative to peers. Other than through trimming of well-performing securities, Highstreet will quickly sell stocks as the result of negative estimate revisions, poor price momentum and adverse fundamental changes to companies' business models. The portfolio is quickly and efficiently refreshed with better ideas.

PORTFOLIO CONSTRUCTION ① ② ③ ④ ❺

Through rigorous monitoring processes, Highstreet is keenly aware of all explicit and implicit bets within their portfolio and is also very sensitive to the risk profile of their portfolio relative to the benchmark. Highstreet will invest in most if not all ten industries, within ±7% of the S&P/TSX Composite Index's weight. Low relative industry deviation mitigates the relative risk of holding roughly 50 stocks.

LOW ① ② ③ ④ ⑤ HIGH

An optimizer is not used to construct the portfolio making the process less quantitatively-oriented compared to other pure quantitative investment managers. Highstreet uses a proprietary risk management tool that is integrated with Barra to aid in portfolio construction and in continuous management of the portfolio risk profile. Previously, this was a two-step process but Highstreet have recently implemented a new Portfolio Construction System (PCS) which links portfolio construction to their risk model and also takes into account trading costs. This includes an in-house Value-at-Risk and Value-at-Benefit analysis that allows Highstreet to quickly assess the statistical downside risk and upside opportunity to their portfolio, and to take any corrective action if necessary. We believe Highstreet's attention to risk is a differentiating and positive feature of their process.

IMPLEMENTATION ① ② ③ ❹ ⑤

Decision-making authority is efficient with Shaun now overseeing the process but working closely with Rob. Shaun was previously responsible for implementation of the core Canadian Equity portfolio with Jeff overseeing so Highstreet maintains that the change in Jeff's role will has not had a notable impact on the process. We now have confidence in Shaun's ability to manage the portfolio on a day-to-day basis without Jeff's involvement.

The implementation of their new Portfolio Construction System (PCS) is improving the efficiency of their process as it works directly with the Charles River trading system and links the risk model directly to portfolio construction and takes trading costs into account. Our discussion of this tool at our meeting confirmed that this has had a positive impact on implementation.

At roughly $2.7 billion in assets under management in the core Canadian Equity product, there are no immediate concerns about the level of assets impairing the process.

LOW ① ② ③ ④ ⑤ HIGH

Manager Update

Highstreet Asset Management Inc.

PRODUCTS REVIEWED

PRODUCT	ASSET CLASS	GEOGRAPHIC EMPHASIS	STYLE	SUBSTYLE
Canadian Equity	Equity	Canada	Market Oriented	Quantitative

MANAGER UPDATE

On October 7, 2008, Phil Chen and Kathleen Wylie met with the team at Highstreet Asset Management Inc. (Highstreet) for a regular update on the firm and the Canadian Equity product. This meeting has increased our confidence in Shaun Arnold, who is the CIO and co-leader of the investment team with Rob Jackson. Rob was recently appointed Chief Risk Officer and co-leader after taking over from Doug Crocker who retired effective September 30, 2008. We remain confident in the team and process and are maintaining our "Hire-4" rank on the Canadian Equity product.

Doug Crocker's retirement from Highstreet was not a surprise and our discussion with Rob confirmed that the transition to him has proceeded smoothly. We were surprised to learn that AGF waived the financial penalty for Doug that was put in place when AGF purchased Highstreet for anyone leaving the firm before the 3-year lock-up period. Our view is that AGF made an exception for Doug since he was nearing retirement age so we are not concerned about more departures in the near term. Interestingly, we learned that Jeff Brown, who was previously the CIO, has been on sabbatical since August and will not return until January. He no longer has direct involvement with the Canadian Equity team so we do not view this as significant.

Stemming from Doug's retirement, ownership has become more broad-based with the 20% of the firm that Highstreet still owns now split between 19 shareholders, which is up from 10 previously. Highstreet would like to see their share eventually increase to 25% and for all employees of the firm to have a stake but that is not likely to happen anytime soon.

Our concern about product proliferation has been alleviated somewhat with two of the three new products Highstreet developed and managed for AGF this year shut down because of a lack of interest. We would prefer that Highstreet focus on the current product line-up so will be monitoring the future introduction of new products closely.

Highstreet demonstrated their Portfolio Construction System (PCS) which links their portfolio construction directly to their risk management system. Relative to other quantitative firms, Highstreet is less sophisticated with their final portfolio decisions made by Shaun rather than an optimizer so their process is not purely quantitative. Highstreet describes their portfolio construction process as a "naïve optimizer." In our opinion, this tool does improve efficiency because it allows them to propose stock weighting changes and see the immediate impact on the overall characteristics and risk profile of the portfolio; however, generally Highstreet's quantitative approach is less sophisticated than other quantitative firms in Canada.

We met with John McNair to discuss Highstreet's research protocol. Again, he did not impress us with his insights and we continue to believe that their process of reviewing models only every three years and their approach to testing of factors lags other quantitative firms that are researching and updating models continuously. However, while we believe that Highstreet's research is only average relative to peer quantitative managers, we continue to believe that their disciplined security selection approach and sell discipline combined with the high quality of investment professionals and attention to risk will continue to result in value added that is consistent with other "Hire" ranked market-oriented managers generally.

Performance

Since Highstreet will take bets at the sector level of up to 7% relative to the S&P/TSX Composite Index, the result is that their performance pattern is often uncorrelated with other quantitative firms that are more sector neutral. This was highlighted in the current extreme environment, where we observed that for managers to consistently outperform, they had to get their Energy, Materials and Financial bets right, therefore, being sector neutral has generally been a more rewarded strategy leading to higher value added. The Barclays Global Investors Canada Active Canadian Equity fund is an example of how well a sector neutral approach has worked. Still, Highstreet is faring well relative to the universe of market-oriented managers with their one-year return ending September 30, 2008 of -14.7% roughly 50 basis points ahead of the median market-oriented manager (which includes a few quantitative firms) but behind the S&P/TSX composite return of -14.4% by approximately 30 basis points.

Highstreet has been overweight the Energy sector during 2008 which helped their performance in Q2 but hurt in Q3. In Financials, Highstreet's underweight heading into Q2 would have helped their performance but then hurt in Q3.

The longer-term numbers over 4- and 5-year annualized periods ending September 30, 2008 are roughly 170 and 230 basis points ahead of the S&P/TSX Composite return respectively. Relative to the median market-oriented manager, their returns are approximately 120 and 150 basis points ahead over the same periods, respectively.

If you have any questions about this manager or product, please contact your client executive.