

Lessons from successful active managers

How the Trimark discipline outperforms

Choosing passive management may seem like a safe bet: fees are low and you're guaranteed returns pretty close to market performance. So why even look at active managers? After all, there's little point in paying extra fees in the pursuit of alpha performance when all you receive are beta returns. However, while active managers are often categorized as having high fees combined with underperformance, the truth is some active managers do outperform. The key to long-term outperformance is to find managers who display the characteristics of effective active management. Here are four indicators that stand out.

- **Thinking independently.** Portfolio managers should seek to be different from the crowd, relying on their investment process and experience to challenge conventional market thinking – for example, by conducting their own research and not relying on industry analysts' recommendations
- **Sticking to one's principles.** Portfolio managers with the discipline to stick to their own style perform better than those who chase performance when other styles are in vogue. Style drift tends to show up most often when a manager's reported style is out of favour; that's when it's most tempting to switch in order to chase returns. Managers who are true to their discipline will typically demonstrate low portfolio turnover
- **Being a good stock picker.** Once the dominant form of investment management, stock picking has dropped in popularity over the last 25 years and has now become a neglected source of potential alpha. Nevertheless, the greatest opportunities for outperformance lie in being different from the benchmark
- **Running a focused portfolio.** Not surprisingly, for a good stock picker, it can be more advantageous to hold a larger weighting in the best stock in a particular industry than to passively buy small amounts of every stock. That's because the biggest bets of focused portfolios are often the ones that add the most value. As a result, concentrated portfolios can outperform those that are more diversified

Too often, indices can become dominated by a particular sector – passive funds offer no downside protection when an investment bubble inevitably bursts.

Studies have shown there are benefits to buying stocks that are institutionally oversold, and similarly selling those that are overbought.



Case study: Trimark Fund

Disciplined active management

Trimark Fund is an excellent example of one of those rare actively managed portfolios with a long-term track record of successfully outperforming its benchmark. All Trimark managers adhere to the same proven investment process and philosophy. As Invesco Trimark's flagship portfolio, Trimark Fund has a broad mandate to invest globally without regard to any industry or country constraints.

Not surprisingly, Trimark Fund demonstrates all four attributes of successful active management.

Willingness to go against consensus opinion. The secret to the managers' success has been to constantly search for opportunities missed by the market. They are willing to appear wrong over the short term, because they strongly believe they will be proven correct over the long term.

Thinking independently begins with a proprietary long-term view on a stock. Potential investments are thoroughly researched using fundamental analysis and are then only purchased when they become available at a price below their intrinsic value. As shown below, with R-squared trending between approximately 40% and 70%, Trimark Fund's portfolio managers have always been willing to think differently.

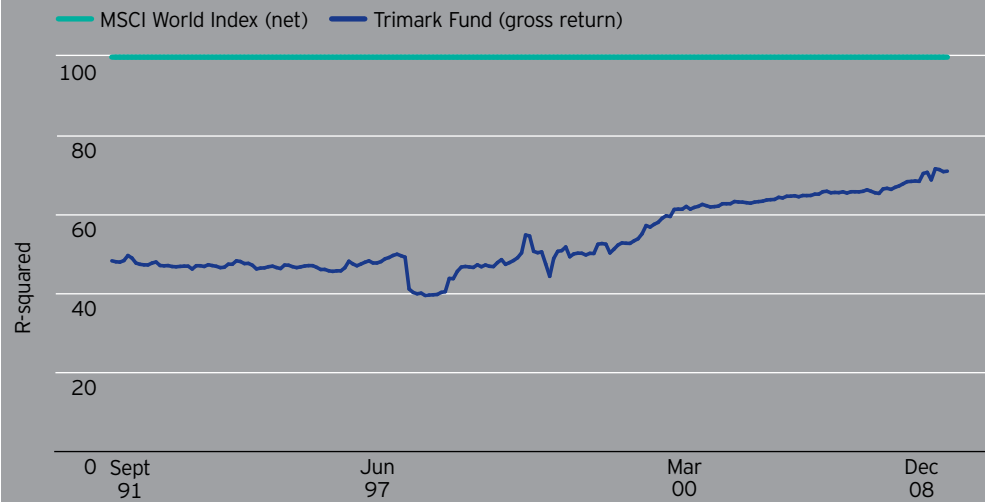
Annualized returns over the 27 years that the Fund has been in existence work out to 13.6% for Trimark Fund versus only 9.0% for the index.

In a typical year, Trimark managers will hold over 800 meetings with companies that are current or potential holdings.

R-squared represents the percentage of a fund's return that can be explained by movements in the index. A fund with an R-squared of 70 or less doesn't act much like the index.

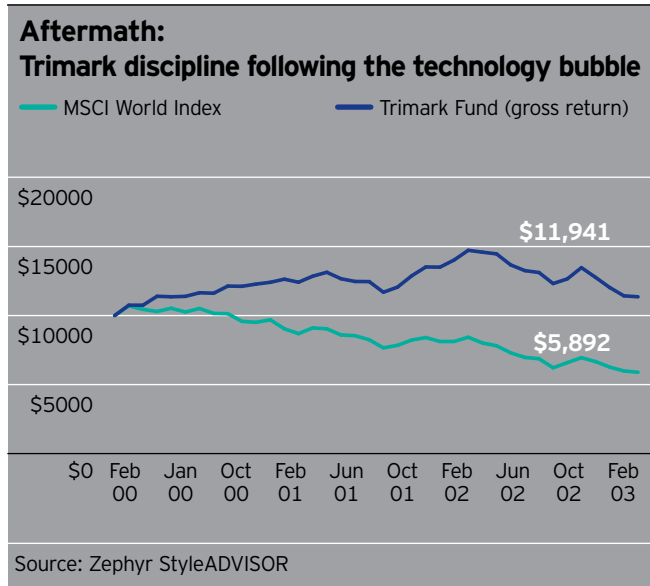
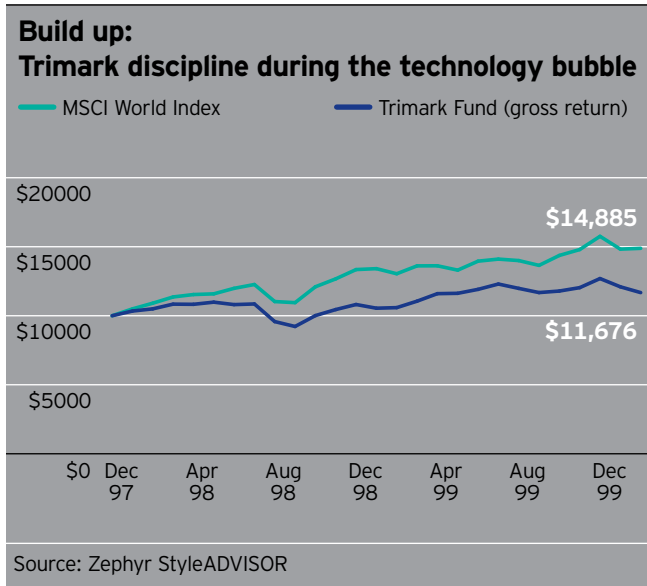
R-squared: Trimark Fund versus benchmark (C\$)

120-month moving windows



Source: Zephyr StyleADVISOR

Being true to a discipline. Trimark’s managers have a well-established reputation for sticking to their investment principles in all manner of market conditions. For example, during the late 1990s when tech and internet stocks were skyrocketing in value, managers had difficulty finding stocks that met their investment criteria. In December 1999, Trimark Fund had only 9% exposure to the sector, versus a 37% weighting for the benchmark. The charts below show how lack of exposure hurt the Fund’s performance during the bubble – and how during the post-bubble period, investors were well rewarded.



\$10,000 invested in Trimark Fund at the beginning of the technology bull market in December 1997 would have been worth \$13,943 by March 2003, versus only \$8,771 in a passive benchmark portfolio.

Tracking error is a measure of a manager's tilts away from the index. A portfolio with high tracking error may depart from the index significantly. Statistically, it is the standard deviation of a fund's excess return over its benchmark.

Information ratio measures a portfolio manager's ability to generate excess returns (relative to its benchmark) by making tilts away from the index. The ratio looks at a fund's returns above its benchmark divided by its tracking error (see definition above). A high ratio means a manager has achieved higher returns more efficiently by taking on additional risk.

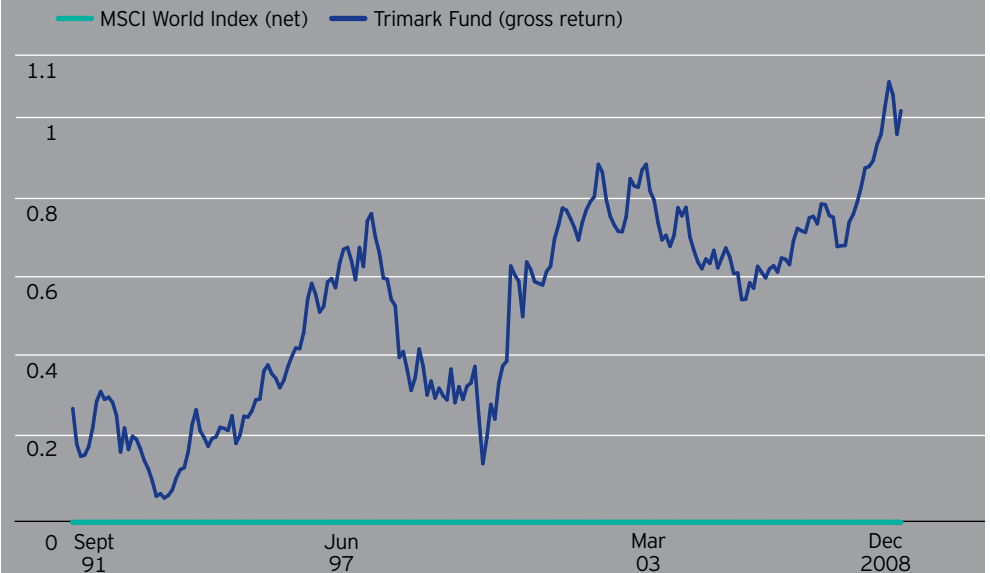
While the portfolio has exhibited a nominally higher risk profile than the index, with an information ratio of 0.45 since inception, this extra risk has been well rewarded. The portfolio's distinctive holdings are reflected in a long-term tracking error of 10% over 27 years of investment history.

Successful stock picking. Since inception, Trimark Fund has always been focused on bottom-up fundamentals with little regard for sector or geographic allocation strategies. The portfolio has shown tracking error of 10.01% versus the market since inception.

Over 10-year periods, the information ratio for Trimark Fund has been trending higher, with the exception of three small dips that coincide with market bubbles.

Information ratio: Trimark Fund versus benchmark (C\$)

120-month moving windows



Source: Zephyr StyleADVISOR

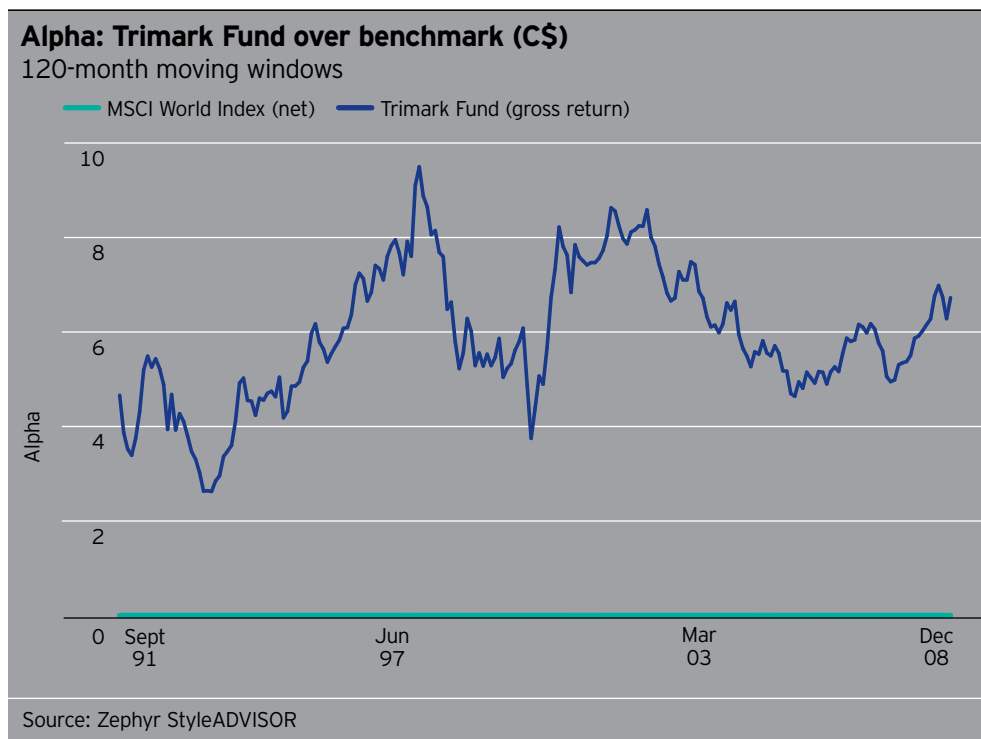
Concentrating on a few excellent holdings. Maintaining such an in-depth interest in every investment forces the portfolio managers to focus on only a small number of selective holdings. For example, over the two-year period 2007-2008, Trimark Fund held only 35 names on average, while the MSCI World Index consisted of an average 1,849 companies.

2007-2008 2-year average	Trimark Fund	MSCI World Index
# of holdings	35	1849

The portfolio is not managed to any benchmark, and decisions are made solely on a stock-by-stock basis. As a result, sector and country weights take on much less importance than the specific holdings. For example, from 2007-2008, Trimark managers did not uncover any companies in the energy sector that met their rigorous investment criteria and could be bought at a discount to intrinsic value. Consequently, investments in this sector were zero, versus weightings of 7.4% in the average Canadian-managed global equity fund and 10.8% in the MSCI World Index.

Active management pays off

The following table and charts show how successfully this disciplined approach to thinking independently has played out since Trimark Fund's inception in September 1981. For example, as shown below, alpha has trended between 4% and 8%, peaking higher in late 1997 and in the aftershocks that followed the rupturing of the technology bubble in 2002.

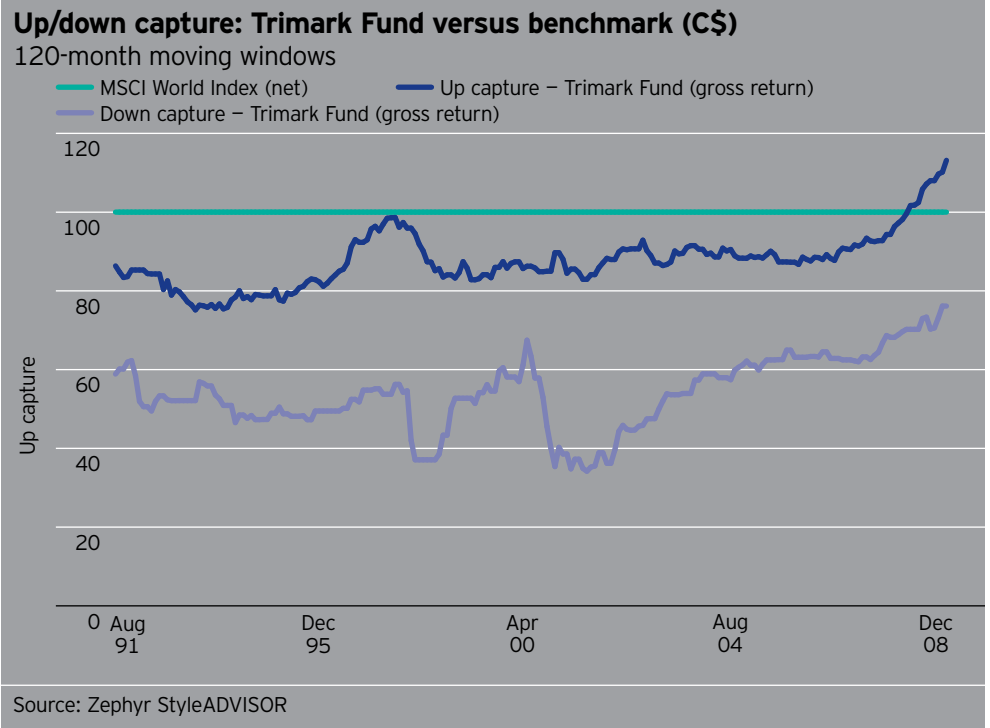


“When the recovery begins, it will not necessarily be the case that a rising tide will lift all boats equally. More than ever, it will pay to be in the right boat.” – Dana Love, Lead portfolio manager, Trimark Fund

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Active managers may often exhibit slightly lower returns during investment bubbles, so it is not surprising to see that Trimark Fund's up capture has ranged between 73% to 100%, and recently has trended above 100% to 113%. On the other hand, a rigorous discipline can effectively provide strong downside protection: Trimark Fund's downside capture has been much lower, varying between 35% and 76%.

The results of the discipline speak for themselves: over the 27 years since its inception in September 1981, the portfolio has a cumulative return more than three times higher than its benchmark index, MSCI World (3,122% vs. 963%).



Add some alpha to the mix

As with anything else, it's important to get what you pay for. There's little point paying the price of active management to a benchmark hugger for returns that are, at best, no better than the index. Instead, seek out active portfolio managers who truly have a process in place that enables them to outperform over the long run. Adding active managers like Trimark to an institutional portfolio can help with overall diversification and give a boost to long-term returns.

Trimark Fund versus MSCI World Index (C\$)

September 1981 – December 2008: annualized summary statistics											
	Return	Cumulative Return	Standard Deviation	Sharpe Ratio	Excess Return vs. Market	Tracking Error vs. Market	Batting Average vs. Market	Information Ratio vs. Market	Up Capture vs. Market	Down Capture vs. Market	R-squared vs. Market
Trimark Fund (gross returns)	13.55%	3122.30%	14.86%	0.47	4.51%	10.01%	56.10%	0.45	93.70%	67.66%	57.42%
MSCI World Index (Net)	9.03%	963.30%	13.76%	0.18	0.00%	0.00%	0.00%	0	100.00%	100.00%	100.00%



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