OShaughnessy
ASSET MANAGEMENT

Thoughts on the Correction

COMMENTARY BY THE OSAM RESEARCH TEAM: MAY 21, 2010

"THE RATIONAL MAN — LIKE THE LOCH NESS MONSTER — IS SIGHTED OFTEN, BUT PHOTOGRAPHED RARELY."

DAVID DREMAN

OSAM RESEARCH TEAM

Jim O'Shaughnessy
Chris Meredith, CFA
Scott Bartone, CFA
Travis Fairchild, CFA
Patrick O'Shaughnessy, CFA
Ehren Stanhope, CFA
Manson Zhu, CFA

From an entirely rational perspective, the last few weeks of volatile market declines have created a strong opportunity for investors. The average stock in the S&P 500 is 13 percent cheaper than it was on April 23, 2010 — a fine bargain considering nothing much has changed about the sales and earnings prospects of these companies, which continue to crush analyst expectations. Still, as of May 21, 2010, 64 percent of S&P 500 companies were oversold — a percentage not seen since March 11, 2009.[1] Unfortunately, fear has and will continue to precipitate selling, when it should do the opposite. Certainly fears over Greece are understandable, but to put it in perspective, Greece accounts for a similar percentage of the EMU's GDP as the city of Atlanta does for the United States.

One fascinating study sheds light on people's behavior in markets like this one and highlights why now is the time to buy, not sell, equities. In the study, originally reported in a *Wall Street Journal* article entitled "Lessons from the Brain-Damaged Investor" and led by researcher Baba Shiv of Stanford University, a group of 41 participants played an investment game where each was given $20 to start and asked to make 20 rounds of one dollar investment decisions based on a coin toss. They would choose either "invest" or "don't invest." If they chose "don't invest," they kept their dollar. If they chose "invest," the researcher took the one dollar and flipped a coin. If it came up heads, the dollar was lost but if it came up tails, the investor was rewarded with $2.50. Clearly the most profitable strategy would be to play every round, as the expected value of each one dollar "invested" is $1.25. The twist in the study was that one group of participants had suffered brain damage which affected key emotional centers in the brain such as the orbitofrontal cortex, the amygdala, or the insula. The other participants had either no brain damage at all or brain damage that affected non-emotional centers of the brain.

Those without any emotional brain damage invested just 58 percent of the time ending with $22.80 on average. Those participants with brain damage outperformed their healthy counterparts by 14.5 percent investing 84 percent of the time and ending with an average of $25.70. The main reason participants with normal brains did so poorly was because of their behavior after a loss. Instead of recognizing the very simple positive expected value of choosing "invest", the normal group was scared of losing twice in a row and as a result invested just 41% of the time after a loss. The damaged group maintained their overall percentage after a loss, investing 85% of the time. This study illustrates that fear, loss, and risk avoidance act as a tax on our portfolios if we do not take action to circumvent their influence.

Real life investors have even better odds of winning than the participants in the study. A coin toss is 50/50, but the stock market goes up 72 percent of the time.[2] What's more, as we have written in several previous commentaries, our research shows that following major declines, those odds are even better as markets consistently revert to the mean.

The year 2009 is a perfect example of the price investors pay for shunning the stock market after a loss. During 2009, the S&P 500 was up 26.4 percent while the Barclay's Aggregate returned just 5.9 percent. During this same time, total flows for equity funds were *negative* $8.6 billion while total flows into bond funds were a staggering $375 billion. Not only were equity flows negative, the vast majority of the selling came at the worst possible time: February and March near the market bottom. Investors acted just as Professor Shiv's participants did after a loss, avoiding what has been demonstrated to be the better investment decision entirely because of fear.

Now is precisely the time that we need to be aware of these tendencies in ourselves and to take action to squash them. We encourage all of our clients to stay calm and, if possible, add money to the market. The yield on the O'Shaughnessy Enhanced Dividend portfolio is 5.8 percent,[3] up from 5.1 percent[4] just three weeks ago. Stocks in our Small to Mid Cap Growth portfolio are 20 percent cheaper on average than they were three weeks ago. If we offered those sorts of deals to prospective investors on April 23rd they would have been thrilled, but one of fear's largest side affects is market paralysis, a reluctance to take advantage of clear opportunities. We encourage everyone to overcome this paralysis and take action.

[1] Weeden & Company

[2] Based on U.S. market data since the founding of the U.S. stock exchange.

[3] As of 5/21/10; Yield is subject to significant change and is not a guarantee.

[4] As of 4/23/10; Yield is subject to significant change and is not a guarantee.

General Legal Disclosure/Disclaimer

The material contained herein is intended as a general market commentary. Opinions expressed herein are solely those of O'Shaughnessy Asset Management, LLC and may differ from those of your broker or investment firm.

Please remember that past performance is no guarantee of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product made reference to directly or indirectly in this presentation, will be profitable, equal any corresponding indicated historical performance level(s), or be suitable for any portfolio. Gross of fee performance computations are reflected prior to OSAM's investment advisory fee (as described in OSAM's written disclosure statement), the application of which will have the effect of decreasing the composite performance results (for example: an advisory fee of 1% compounded over a 10-year period would reduce a 10% return to an 8.9% annual return). Due to various factors, including changing market conditions, the content may no longer be reflective of current opinions or positions. Moreover, you should not assume that any discussion or information contained in this presentation serves as the receipt of, or as a substitute for, individualized investment advice from OSAM. Historical performance results for investment indices and/or categories have been provided for general comparison purposes only, and generally do not reflect the deduction of transaction and/or custodial charges, the deduction of an investment management fee, nor the impact of taxes, the incurrence of which would have the effect of decreasing historical performance results. It should not be assumed that any account holdings would correspond directly to any comparative indices. Account information has been compiled solely by OSAM, has not been independently verified, and does not reflect the impact of taxes on non-qualified accounts. In preparing this presentation, OSAM has relied upon information provided by the account custodian and/or other third party service providers. OSAM is a Registered Investment Adviser with the SEC and a copy of our current written disclosure statement discussing our advisory services and fees remains available for your review upon request.

Backtested Results

Hypothetical performance results shown on the preceding pages are backtested and do not represent the performance of any account managed by OSAM, but were achieved by means of the retroactive application of each of the previously referenced models, certain aspects of which may have been designed with the benefit of hindsight.

The hypothetical backtested performance does not represent the results of actual trading using client assets nor decision-making during the period and does not and is not intended to indicate the past performance or future performance of any account or investment strategy managed by OSAM. If actual accounts had been managed throughout the period, ongoing research might have resulted in changes to the strategy which might have altered returns. The performance of any account or investment strategy managed by OSAM will differ from the hypothetical backtested performance results for each factor shown herein for a number of reasons, including without limitation the following:

- Although OSAM may consider from time to time one or more of the factors noted herein in managing any account, it may not consider all or any of such factors. OSAM may (and will) from time to time consider factors in addition to those noted herein in managing any account.
- OSAM may rebalance an account more frequently or less frequently than annually and at times other than presented herein.
- OSAM may from time to time manage an account by using non-quantitative, subjective investment management methodologies in conjunction with the application of factors.
- The hypothetical backtested performance results assume full investment, whereas an account managed by OSAM may have a positive cash position upon rebalance. Had the hypothetical backtested performance results included a positive cash position, the results would have been different and generally would have been lower.
- The hypothetical backtested performance results for each factor do not reflect any transaction costs of buying and selling securities, investment management fees (including without limitation management fees and performance fees), custody and other costs, or taxes – all of which would be incurred by an investor in any account managed by OSAM. If such costs and fees were reflected, the hypothetical backtested performance results would be lower.
- The hypothetical performance does not reflect the reinvestment of dividends and distributions therefrom, interest, capital gains and withholding taxes.
- Accounts managed by OSAM are subject to additions and redemptions of assets under management, which may positively or negatively affect performance depending generally upon the timing of such events in relation to the market's direction.
- Simulated returns may be dependent on the market and economic conditions that existed during the period. Future market or economic conditions can adversely affect the returns.