

## Enhanced Index Russell 1000 Strategy

SOLUTIONS & MULTI-ASSET | APPLIED EQUITY ADVISORS TEAM | STRATEGY PROFILE | 2017

The Applied Equity Advisors **Enhanced Index Russell 1000 Strategy** seeks to achieve Russell 1000 Index-like returns after fees. By employing quantitative models, the team aims to identify 200-300 stocks that, in aggregate, have exposure to factors it believes will drive returns in the current market environment.

The final portfolio is designed to have a modest tracking error and align closely with the Russell 1000 Index in terms of industry, sector, style and company size.

### Philosophy: Factor-based investing, unconstrained by style

We believe common, market-oriented factors drive the majority of equity returns. Over the last 20 years, market-driven factors have explained about 65% of the relative performance of global separate account managers.<sup>1</sup> Our goal is to extract value from these return drivers.

Using proprietary methodology, we seek to identify those factors most likely to produce excess returns in the current environment. Through quantitative modeling and screening, we then tilt the portfolio toward stocks with exposure to those factors.

### Process: Oriented toward achieving desired factor exposures

Relying solely on proprietary quantitative models, the team seeks to identify factors that will dominate markets over the next 6-12 months. Over 40 factors are ranked based on their momentum strength and cheapness (valuation) to identify potential opportunities. These factors fall into five categories:

- Valuation
- Growth
- Quality
- Risk
- Momentum

Stocks are then ranked by their relative exposure to the desired factors, which narrows the universe to the top quintile (20%) of stocks. To further refine the pool, each high-scoring stock undergoes risk decomposition analysis to assess its effect on desired and undesired exposures.

### STRATEGY AT A GLANCE

Inception date	November 30, 2007
Investment style	Core Equity
Securities	U.S. equity securities
Typical no. of holdings	200-300
Target active share	≥ 60%
Target tracking error	1.5-2.0%

Please refer to the Distribution disclosures at the end for additional information.

**DISPLAY 1**

**An index-like portfolio, tilted toward prevailing market factors**

Using proprietary quantitative models, the team seeks to identify factors that will dominate markets over the next 6-12 months.

Determine dominant factors for positioning

Stocks are ranked by their exposure to desired factors, narrowing the universe to the top quintile (20%) of stocks.

Screen stocks and decompose risks

To further refine the pool, high-scoring stocks undergo risk decomposition analysis to assess their effects on desired and undesired exposures.

A diverse portfolio of 200-300 stocks is constructed to align closely with the Russell 1000 Index in terms of industries, sectors, styles and market capitalization.

200-300 stocks

*This represents how the portfolio management team generally implements its process under normal market conditions.*

**Investment team: Strong leadership, highly experienced<sup>2</sup>**

Andrew Slimmon is a Managing Director at Morgan Stanley Investment Management, where he is the lead Senior Portfolio Manager on all long equity strategies for Applied Equity Advisors. Andrew is also a member of the Morgan Stanley Wealth Management Global Investment Committee. He has 30 years of investment management experience. He began his career at Morgan Stanley in 1991 as an Advisor in Private Wealth Management, and later served as the Chief Investment Officer of the Morgan Stanley Trust Company.

Phillip Kim is a Portfolio Manager for Applied Equity Advisors strategies, overseeing the team’s quantitative equity research. Previously, he was a Quantitative Research Analyst for Morgan Stanley Smith Barney’s Alternative Investment Research. Mr. Kim also worked as a software engineer at Raytheon, where he was responsible for the design of the world’s first high-altitude, long-endurance unmanned aerial vehicle (UAV). Mr. Kim also worked at Pricewaterhouse Coopers as a financial model developer.

**Competitive advantages**

**UNCONSTRAINED BY STYLE**

Portfolio is positioned to gain exposure to broad market factors the team believes will drive returns in the current market environment. The process seeks to protect investors from prolonged periods of style-driven underperformance.

**FOCUSED ON LIMITING VOLATILITY AND TRACKING ERROR**

To manage tracking error and overall volatility, the team seeks to closely align the portfolio’s sector weightings, average market capitalization and beta with the Russell 1000 Index.

**INDEX-LIKE INVESTING, WITH AN ACTIVE TILT**

By constructing a portfolio that closely mirrors the characteristics of the Russell 1000 Index, and tilting it toward potential alpha-generating factors, investors have the possibility of realizing index-like returns on an after-fee basis.

<sup>1</sup> Source: Morningstar. Based on Rolling 18-month R-squared for Global Equity Managers Time Series Regression. Information as of December 31, 2015. **Past performance is not indicative of future results.** For illustrative purposes only.

<sup>2</sup> Team members may change without notice from time to time.

## Risk Considerations

There is no assurance that a Portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market values of securities owned by the Portfolio will decline and may therefore be less than what you paid for them. Accordingly, you can lose money investing in this Portfolio. Please be aware that this Portfolio may be subject to certain additional risks. In general, **equities securities'** values also fluctuate in response to activities specific to a company. Stocks of **small-and medium-capitalization companies** entail special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities of larger, more established companies. Investments in foreign markets entail special risks such as currency, political, economic, market and liquidity risks. **Illiquid securities** may be more difficult to sell and value than publicly traded securities (liquidity risk). **Non-diversified portfolios** often invest in a more limited number of issuers. As such, changes in the financial condition or market value of a single issuer may cause greater volatility.

### DEFINITIONS:

**Weighted average market capitalization** is a stock market index weighted by the market capitalization of each stock in the index. **Price-earnings ratio (P/E)** is a valuation ratio of a company's current share price compared to its per-share earnings. Calculated as Market Value per Share/Earnings per Share. **Portfolio turnover** is a measure of how frequently assets within a portfolio are bought and sold by the managers. Portfolio turnover is calculated by taking either the total amount of new securities purchased or the amount of securities sold—which ever is less—over a particular period, divided by the total net asset value of the fund. **Dividend yield** is the ratio between how much a company pays out in dividends each year relative to its share price. **Active share** is the fraction of the portfolio that is invested differently than its benchmark as of the last day of the reporting period. A portfolio with a high degree of active share does not assure a portfolio's relative outperformance. The typical active share and the number of holdings represent typical ranges and are not a maximum number. The **targets** presented are typical ranges. There is no assurance that these targets will be attained. The portfolio may exceed these from time to time due to market conditions and outstanding trades. **Alpha** is the excess return or value added (positive or negative) of the portfolio's return relative to the return of the benchmark. **Beta** is a measure of the volatility, or systematic risk, of a security or a portfolio in comparison to the market as a whole. **Standard deviation** measures how widely individual performance returns, within a performance series, are dispersed from the average or mean value. **Upside capture** is a statistical measure of an investment manager's overall performance in up-markets. **Downside capture** is a statistical measure of an investment manager's overall performance in down-markets. **Tracking error** is the amount by which the performance of the portfolio differs from that of the benchmark. The **Russell 3000® Index** measures the performance of the largest 3,000 U.S. companies representing approximately 98% of the investable U.S. equity market. The Russell 3000 Index is constructed to provide a comprehensive, unbiased and stable barometer of the broad market and is completely reconstituted annually to ensure new and growing equities are reflected. The **Russell 1000® Index** is an index that measures the performance of the 1,000 largest companies in the Russell 3000 Index. The **S&P 500® Index** measures the performance of the large cap segment of the U.S. equities market, covering approximately 75% of the U.S. equities market. The Index includes 500 leading companies in leading industries of the U.S. economy. The **MSCI World Index** is a free float adjusted market-capitalization-weighted index that is designed to measure the global equity market performance of developed markets. The term "free float" represents the portion of shares outstanding that are deemed to be available for purchase in the public equity markets by investors. The performance of the indices is listed in U.S. dollars and assumes reinvestment of net dividends. The indices do not include any expenses, fees or sales charges, which would lower performance. The indices are unmanaged and should not be considered an investment. It is not possible to invest directly in an index.

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