

WEEKLY MARKET MONITOR

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BRETT HAMMOND
CHIEF INVESTMENT
STRATEGIST

LEO KAMP
CHIEF ECONOMIST

DOUGLAS FORE
DIRECTOR OF PORTFOLIO
ANALYTICS

FUNDAMENTAL EQUITY RESEARCH

From the outside looking in, the equity research and investment process is shrouded in mystery. The *deus ex machina* from whom returns are generated appears unfathomable. Successful organizations appear to have divined some secret unknown or even unknowable to others. By contrast the much longer list of unsuccessful organizations appear condemned to an endless purgatory of mediocrity or worse. The qualities that comprise a successful organization are at once known within the investment management industry but surprisingly hard to create. This week we will explain the crucial attributes of a successful equity research organization:

- The basic structure of fundamental equity research
- The essential attributes
- The permanent quest for competitive advantage

Fundamental equity research and management has a lot in common with quantitative equity research, the other dominant methodology in equity research and management. Both establish and utilize screens of the appropriate investable universe. Indeed the screens themselves tend to be similar and the output of the investment process — deciding which stocks to buy and which to sell — can be identical. The output of the investment process — and hence the returns to investors — can be very different, however.



In essence, fundamental equity research is a process which operates on multiple levels. These levels consist of analysts and portfolio managers working in concert with the senior equity management team and the risk management team to set overall goals for the levels and types of equity risks desired to achieve the investment goals of the organization. Let us consider each in turn.

The investment process begins with the analyst. In some organizations equity analysts are hired straight out of business school. These organizations tend to be more successful at marketing than at the difficult business of investment management. Successful organizations, by contrast, realize that you cannot expect old heads on young shoulders. Investment management is a ruthless Darwinian business and consequently experience and success are highly correlated and highly valued.

The United States is the world's largest economy and largest equity market. Even so, the U. S. by itself represents less than one-third of the global economy and less than one-half of the global equity market. The fact that investors can gain exposure to somewhat more than half of the world's equity capital by investing outside of the U.S. has obvious implications for equity management teams within the U.S. Until very recently most investment management organizations within the U.S. were organized on purely national lines. In other words an analyst for, say, the auto industry, would be responsible for auto and auto-parts companies within their national market and only their national market. This structure does not, however, reflect the reality of today's global capital markets. In terms of the total equity market capitalization of the global auto industry, the U.S. auto industry is today but a small fraction. Indeed the equity market capitalization of the entire U.S. auto and auto-parts industry is today but a virtually insignificant fraction of the equity market capitalization of certain individual firms in Asia or Europe. This reflects the collective judgment of global investors concerning the future profit streams of these companies. The larger point here is that analysts who follow only domestic companies within global industries are much less likely to succeed and generate returns for their investors in today's competitive global economic and financial marketplace.

Successful organizations are organized on global lines to cover global industries. Analyst teams embody global expertise and cover firms regardless of national boundaries. This is the case in all sectors ranging from financial services to health care to natural resources to consumer goods to technology. Analysts in turn must have expertise both broad and deep, ranging from detailed knowledge of firms and industries to knowledge of global macroeconomic trends and global accounting standards. Knowledge of the dominant languages in the analysts' particular sector is useful. Gaining and maintaining this demanding skill set is extremely difficult. Utilizing this skill set to generate industry-beating investment returns is more difficult still.

Analysts in turn make recommendations to portfolio managers who construct portfolios of individual stocks with the goal of outperforming their relevant investment benchmarks. From a universe of thousands of investable stocks, portfolio managers utilize analyst recommendations to construct portfolios of stocks trading at discounts to their underlying intrinsic values. The goal is to identify undervalued stocks before other market participants and subsequently to benefit from price appreciation when the rest of the market catches up. This requires a very high degree of conviction. The pressure to identify with high conviction stocks which are severely undervalued — and overvalued — vis-à-vis the global equity markets is an extremely demanding skill of which few become master. Portfolio managers look for temporarily undervalued stocks which contain catalysts for price appreciation. Catalysts include favorable competitive positioning, technological adoption, the potential for restructuring and the firm's use of capital. Valuation metrics include the stock price relative to the firm's earnings; equity market capitalization relative to the net value of the firm's assets; equity market capitalization relative to the firm's revenues and the amount of cash flow generated by the firm as a percentage of equity market capitalization. All of these metrics may be considered as variations on a single theme: The price of a stock is a function of its stochastic discounted payoff at an appropriate time in the future.

Since the future is not known, analysts and portfolio managers build forward-looking models incorporating a range of scenarios. By definition the equity markets are forward looking and so the price of an individual stock is the weighted outcome of the forward-looking judgment of all of the participants in the market. Successful analysts and portfolio managers are those able — over time — to identify and act on opportunities with favorable risk/return characteristics.

Conviction must be exercised with discipline and hence success — and failure — rests in large part on the discipline brought to bear on the investment management process. If individual positions are too small, their contribution to total investment returns is in turn too small to warrant the research effort expended. If investment positions are too large, the consequences of error — and the best ideas fail with some regularity — can cause a portfolio manager to trail their benchmark for an entire year. Successful organizations believe in the prudent deployment of risk, not in risk-taking as an end in itself.

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Brett Hammond, Leo Kamp and Douglas Fore are available to comment on economic data. If you wish to speak with them, please contact Chad Peterson, Media Relations, 212-916-4808 or email cpeterson@tiaa-cref.org.

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