

RBC O'Shaughnessy US Value Sr A

Morningstar Opinion March. 19, 2014

Jim O'Shaughnessy has been running his funds with a similar investment philosophy since 1997. He identified quantitative metrics that successful stocks tend to have. His approach is based on the assumption that historical trends persist and that today's stocks with these same characteristics will be tomorrow's winners. He does no research on specific stocks or industries; his quantitative model alone drives buy and sell decisions.

All the energy of the management team goes into research and model development, as well as refining execution. While its philosophy has remained the same, its model and investing process have evolved through the years. After hitting a rough patch during the financial crisis, when management admitted to complacency in development, O'Shaughnessy significantly updated his model in mid-2011. While changes seem reactive, they are sensible and have shown positive results early on.

The model runs a more concentrated approach than many of its quantitative peers, allowing high-conviction stocks to gradually build up their portfolio weight. This helped the fund achieve good results in 2013, when high-conviction names such as Ameriprise Financial and Seagate Technology significantly outperformed the benchmark (Russell 1000 Value Index). By the end of the year it added more than 15% over its U.S.-dollar benchmark, returning 48% (using the US dollar benchmark is appropriate since the fund is fully hedged to the Canadian dollar). It also outperformed the median fund in the U.S. Equity category by close to 9% despite the depreciating Canadian dollar.

Investors should moderate their expectations, as management expects more subdued long-term returns. Also, the latest version of the model hasn't experienced a down market, so it's unclear how it would fare over a full market cycle. Management's relatively concentrated portfolio could also hurt, at least in the short term. That said, longer-term results are strong, especially versus its Canadian peers, even after controlling for currency returns.

The fund's low price adds a lot to its appeal since it's competing in the very efficient market of large-cap U.S. stocks.

People March. 19, 2014

Jim O'Shaughnessy is chairman, CEO, and CIO of O'Shaughnessy Asset Management (OSAM) in Stamford Connecticut, in which RBC bought a 10% stake in 2008. He has been the lead portfolio manager of this fund for 17 years; his role, however, is more focused on research, as execution is driven by the quantitative model. He is the author of *What Works on Wall Street*. O'Shaughnessy is the primary driver behind the quantitatively based philosophy underlying all the funds.

He is supported by a research team of five and a trading team of four. The research team does not delve into individual stocks. It is involved with developing the model and back-testing data to ensure the consistency of factors. A component of the researchers' compensation is based on their contribution in creative ideas that would enhance the model. While the team might not be as strong in academic credentials as some of their larger quant-driven competitors, its members are experienced and have worked together for a long time. Under O'Shaughnessy's leadership the team had reasonable success in managing value strategies, though it did not fare as well on growth funds.

Because they are based in the U.S., the manager and his team can't invest directly in this fund, but they do invest in the underlying strategy. All employees at OSAM are restricted from investing in individual stocks and have to invest in their strategies.

Parent Oct. 10, 2012

RBC Global Asset Management Inc. (RBCGAM) has evolved since Royal Bank of Canada bought fund giant Phillips, Hager & North Investment Management Ltd. (PH&N) in 2008. The two entities have certain common ground with the integration of the leadership of both firms, but there are also clear differences, notably with the PH&N team being based out of Vancouver while RBC is in Toronto.

While RBCGAM has a remarkably effective sales arm, it has done a good job of not letting that dominate the process, and it has a well-developed investment focus. The firm has seen significant changes in its senior ranks in recent years, but much of that turnover has since levelled off. By and large, the integration of PH&N within RBC has been beneficial for both.

While compensation for investment professionals at the firm has a component based on long-term fund performance, which we view favourably, only partial detail was provided regarding direct ownership of fund units by portfolio managers, which we see as the best way to align their interests with those of their investors.

Both RBCGAM and PH&N have long been, and continue to be, price leaders in the Canadian market, with most of their funds having management-expense ratios among the lowest in their respective categories.

Process: Investment Approach March. 19, 2014

The process starts with the model ranking all stocks with a market capitalization above US\$200 million that trade on the three main U.S. exchanges using four main investing themes. Three of the themes concern the quality of firms, and in particular balance sheet strength, earnings quality and earnings growth.

The value theme assures that only quality firms that are attractively priced will rank high in the model and includes commonly used factors such as P/S, P/E, EBITDA/EV, FCF/EV and shareholder yield (this includes dividend yield and share buybacks). Shareholder yield is then used separately as a fifth theme to select the 25 highest ranking stocks to be included in the portfolio. A significant update in the model took place in mid-2011, adding multiple factors in each theme to remove the cyclicity effect of any individual factor.

After 2009 the fund switched from a yearly to a monthly rebalancing. Stocks that re-appear in the model's top 25 ranked names are increased in weight, while stocks that rank lower are gradually decreased. This way, stocks that the model continuously favours become the largest positions.

The most qualitative part of the process is trading, where the team pays close attention to market impact and has suggested that it has added significant value since the introduction of the monthly rebalancing. RBC hedges the fund's U.S. dollar exposure.

Process: Portfolio Positioning March. 19, 2014

Unlike many other quantitatively based funds that use the computational strength of their models to assess all possible stocks and manage portfolios that include a large number of them, this fund takes a

more concentrated approach. After the 2011 updates, the portfolio can have as few as 25 stocks, but in reality will have around 50, while being relatively top heavy. At the end of the year the top-10 holdings accounted for about 37% of the portfolio.

The absence of any sector constraints means that sector allocation is purely driven by the bottom-up characteristics of the individual stocks. At year-end, the model was favouring consumer discretionary stocks at an 18% overweight versus its benchmark, the Russell 1000 Value, as well as an 11% overweight in technology stocks. These allocations are achieved at the expense of a 20% underweight in financial services stocks and an 8.9% underweight in the energy sector. Utilities have been excluded by management, as the highly regulated sector tends to always score high in the model's rankings, while back-tests have shown no edge in picking the right stocks.

Though the fund only invests in U.S. equities, American Depository Receipts can be included because technically they are listed on U.S. exchanges. At the end of 2013, they made up about 6% of the portfolio.

Performance March. 19, 2014

The fund's A series has been around since late 1997 and is benchmarked to both the S&P 500 and, more appropriately, to the Russell 1000 Value Index. Since inception, it has been fully hedged to the Canadian dollar, so it should be compared to U.S.-dollar-denominated benchmarks.

Since inception the fund has returned 6.2% annually, compared to a 2.5% average return in the U.S. Equity category. Close to 1.5% of that outperformance can be attributed to the Canadian dollar's appreciation over that time, but even after stripping the currency boost, it has significantly outperformed. It has also surpassed the 5.8% return of the S&P 500 (US\$) while slightly lagging the 6.7% of the Russell 1000 Value (US\$).

The Canadian dollar depreciated by close to 6.9% during 2013, but despite the headwind, the fund managed to outperform most of its unhedged peers, as a 47.5% return placed it in the top decile of the category. Good stock selection and more specifically the outperformance in some high-conviction names such as Ameriprise Financial and Seagate Technology were the main contributors.

The source of the outperformance supports the recent updates on the model. And while some could argue changes to the model makes past performance irrelevant, management says returns have been almost perfectly correlated with older versions of the model.