MANNING & NAPIER ADVISORS, INC. WHITE PAPER

Evaluating the Merits of Active Management

EVALUATING THE MERITS OF ACTIVE MANAGEMENT

Introduction

The merits of active versus passive management are one of the major ongoing debates in the investment industry today. Proponents of passive management generally believe the equity markets are "efficient" and that all available information is already reflected in current security prices. As such, in-depth analysis would be of limited use and the average, or even professional, investor would be unlikely to consistently outperform the market. Given these beliefs, advocates of passive management advise investors to simply buy a broad market index (e.g., the S&P 500 Index[1]) as a means of gaining market exposure. In contrast, proponents of active management believe that the markets are, in fact, inefficient and that new information is not immediately and properly reflected in equity prices. Thus, through in-depth analysis investors can uncover information not currently reflected in a stock's price and identify attractive investment opportunities in comparison to the market as a whole. While many of the concepts behind the active/passive debate are largely theoretical, in the real world, the winner of the active versus passive management debate is often determined in terms of relative performance. Specifically, researchers have analyzed the ability of active managers to consistently outperform the broad equity markets, with numerous studies concluding that the average active manager generally fails to outperform the broad equity markets on a consistent basis. However, other studies have shown that certain active managers consistently provide superior results.

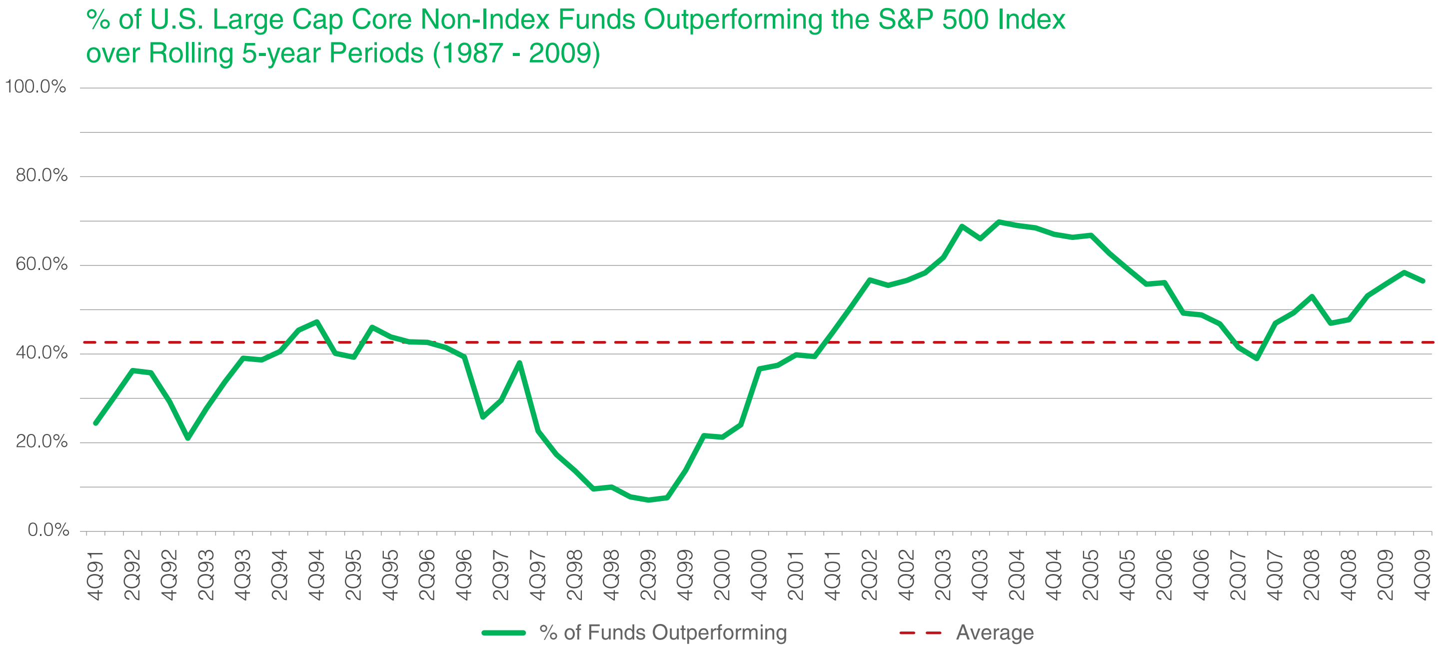
In an effort to provide additional insight into the active/passive debate, the following analysis attempts to answer three basic questions. First, how can investors distinguish between truly active managers and passive managers who may be charging active management fees for benchmark-like portfolios and performance? Second, once a subset of truly active managers has been determined, how does their performance compare versus a broad market index? Lastly, what factors affect the relative performance of active managers versus market benchmarks at any given point in time? As such, the first section of this analysis summarizes the concept of active share as a means of distinguishing between managers who are truly active and those with benchmark-like portfolios. The second section of this analysis presents evidence that the performance of truly active managers may in fact be attractive relative to market benchmarks and their peers. Finally, the third section provides a brief overview of several variables that may affect the relative performance of active managers with special focus on the importance of the current market environment.

Using Active Share to Identify Active Managers

How can an investor determine whether their manager is active? The simplest approach would probably involve searching a broad manager/mutual fund database, such as Morningstar, and determining whether any given strategy is classified as an index fund (i.e., with a primary investment objective of tracking a market index). If managers not classified as index funds are considered active, then comparing their performance versus the appropriate broad market index could be used to evaluate the merits of active management. To initially evaluate the performance of active managers, a universe of core-oriented U.S. large cap equity mutual funds[2] in the Morningstar database, excluding index funds, was constructed. The performance of the universe was then compared versus the S&P 500 Index, a widely accepted U.S. large cap equity benchmark. Specifically, the analysis evaluated the relative performance of the median large cap core fund versus the S&P 500 Index over rolling five-year periods from 1/1987 – 12/2009, as well as the percent of funds that outperform the benchmark over each rolling five-year period. As the charts on the following page illustrate, while certain time periods have been more/less favorable for active managers, overall there does not appear to be strong evidence that non-index fund managers consistently outperform. For example, over any given five-year period, on average, only 42% of the non-index funds outperformed the S&P 500 Index, on a net-of fees-basis, and the median non-index fund underperformed the benchmark by approximately -0.67% net-of-fees (annualized) on average.

[1]The S&P 500 Total Return Index is an unmanaged capitalization-weighted measure of 500 widely held common stocks listed on the New York Stock Exchange, American Stock Exchange, and the Over-the-Counter market. The Index returns assume daily reinvestment of dividends, and do not reflect any fees or expenses. Index returns provided by Morningstar.

[2]Represents all mutual funds in the Morningstar Direct Database with a Morningstar Institutional Category of: All Cap Core, Giant Core, Large Core, Large Valuation Sensitive Growth, or Large Relative Value as of May 2010. The oldest share class of each mutual fund is utilized.



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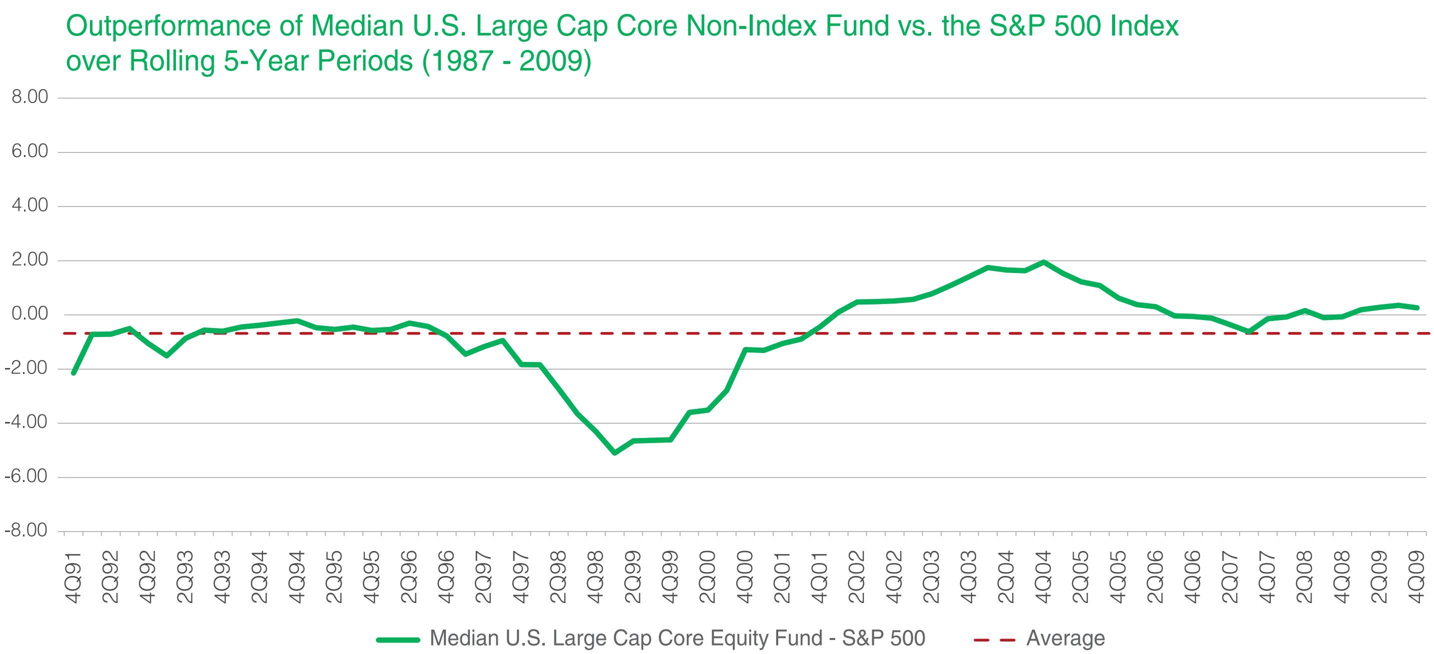
Data provided by Morningstar



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However, before drawing conclusions regarding the merits of active management based on this data alone, it is important to take a closer look at the appropriate definition of active management. For example, are managers who do not classify themselves as index funds truly active and is there additional information that may help investors determine how active a specific manager is?

It can be argued that a manager is making active decisions if their portfolio somehow differs from the benchmark. For example, few would argue that a large cap U.S. equity manager who holds all the securities in the S&P 500 Index in the same proportions as the index is active when compared to the S&P 500. Conversely, a manager that only holds two or three S&P 500 stocks is making active decisions versus the index. Since none of the mutual funds in the universe described above are index funds, a method must be developed to determine which ones are truly making active decisions.

A concept that attempts to analyze active management is called Active Share. Active Share was developed by professors at the Yale School of Management and is presented in a study originally published in 2006 and updated in March of 2009. In general, active share measures the difference between an investment manager's portfolio and the benchmark on a holdings basis. Differences may arise from managers not holding securities included in the benchmark, holding securities other than those included in the benchmark, or holding securities in different weights than are found in the benchmark. A portfolio's active share will range between 0% and 100%. Managers with greater active share generally have portfolios that are more distinct from the benchmark and are thus making greater "active decisions". By analyzing active share, investors can evaluate the specific "active" decisions a manager is actually making and can also more easily identify "closet indexers" (active managers with benchmark-like portfolios). Unlike tracking error, which quantifies differences between a portfolio and benchmark based on historical return data, and may or may not be reflective of how similar or not a manager's holdings are to a benchmark, active share provides insight into a manager's current/historical portfolio holdings which are more likely to determine future performance. The results of the original study show that managers with high active share generally outperform their benchmarks, with those results showing a degree of persistence, while non-index managers with low active share generally underperform their benchmarks.

Relative Performance of High Active Share Managers

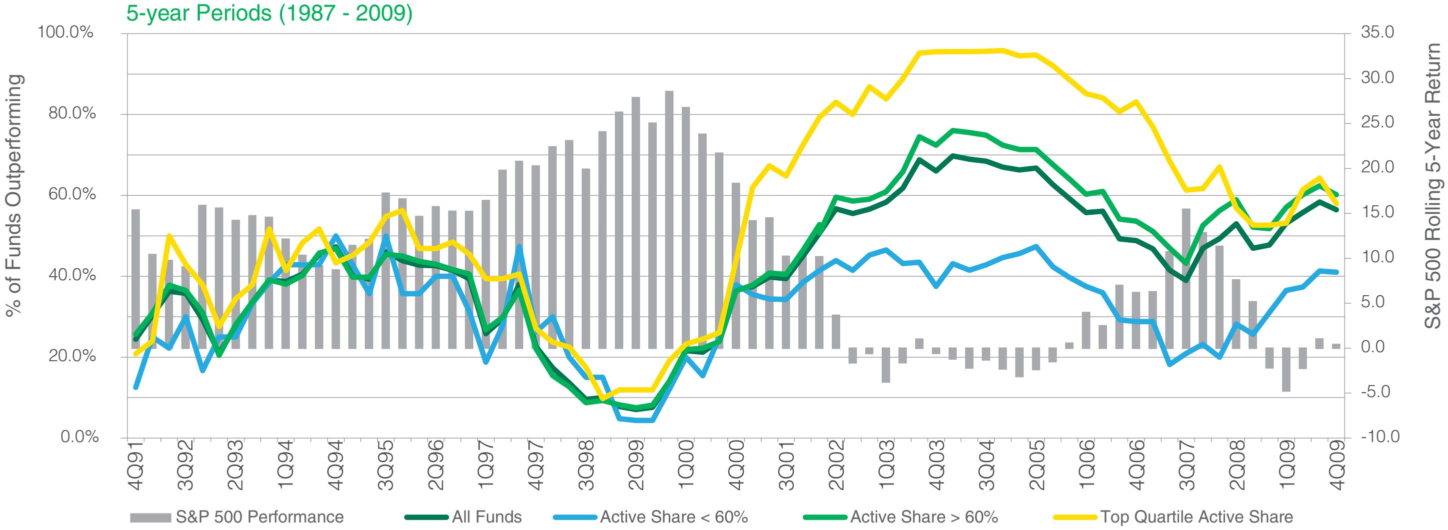
Utilizing active share, our original U.S. large cap core non-index equity mutual fund universe (shown in the charts on the previous page) can now further be segmented into managers that are truly active (i.e., with high active share) and those considered "closet indexers" (i.e., with low active share). As such, for each U.S. large cap core non-index fund included, calendar year-end active share versus the Vanguard 500 Index Fund (as a proxy for the S&P 500 Index) from 12/31/87 – 12/31/09 was calculated for periods where holdings data was available (i.e., 23 active share calculations for a fund with complete holdings data from 12/87 – 12/09). The charts on the following page repeat the large cap core mutual fund relative performance analysis with the universe segmented into several active share groups.

As the Yale study classified active managers as those with an active share of greater than 60%, the first group represents mutual funds with an active share of greater than 60%, and thus considered to be active as per the original study. The second group represents funds with an active share of less than 60% (i.e., those likely to operate with more index-like portfolios). However, it can also be argued that even managers with an active share of 60% have substantial portfolio overlap with their respective benchmarks and only managers with active shares above 80% or even 90% are likely to have truly distinct portfolios. Thus the third group represents funds whose active share fell in the top quartile of the universe (i.e., approximately 85% and above) and can thus be considered truly active. As the charts illustrate, funds with an active share of less than 60% tend to perform worse relative to the overall universe, and over any given five year period, on average only 32% of the low active share funds outperformed the S&P 500 Index. Furthermore the median fund in the low active share group underperformed the benchmark by approximately -0.73% net-of-fees (annualized) on average.

In contrast, results for funds with top quartile active shares look comparatively superior. In fact, over any given five year period, on average 56% of the top quartile active share funds outperformed the S&P 500 Index and the median fund in the group outperformed the benchmark by approximately 0.77% net-of-fees (annualized) on average. Thus, the evidence appears to suggest that while the performance of the average non-index manager versus the broad equity market may not be impressive, focusing on managers that are truly active (i.e., those with high active share) may provide more favorable results.

EVALUATING THE MERITS OF ACTIVE MANAGEMENT

% of U.S. Large Cap Core Non-Index Funds Outperforming the S&P 500 Index over Rolling 5-year Periods (1987 - 2009)



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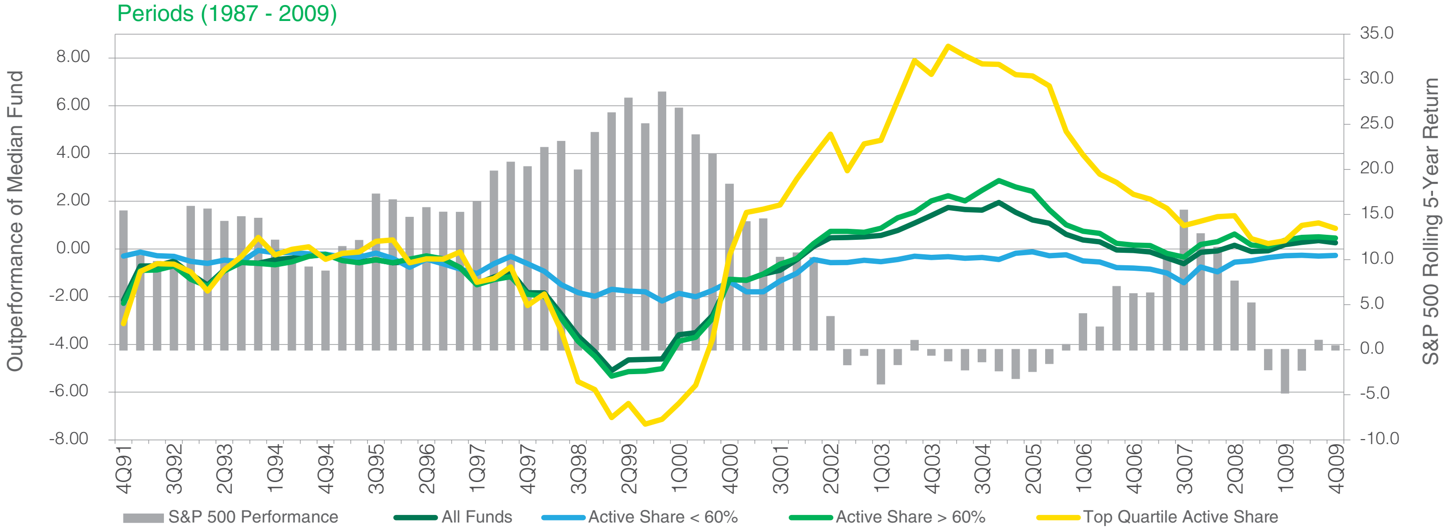
Data provided by Morningstar

Outperformance of Median U.S. Large Cap Core Non-Index Fund vs. the S&P 500 Index over Rolling 5-Year Periods (1987 - 2009)



Analysis by Manning & Napier Advisors, Inc.
Data provided by Morningstar

Evaluating the performance of active managers in the context of market conditions may help investors to better understand the sources of their manager's performance and potentially avoid costly manager turnover during environments where the benchmark becomes an especially difficult performance hurdle. For example, the charts above illustrate that during the five year period ending on 9/30/99 only approximately 10% of U.S. large cap core non-index mutual funds outperformed the S&P 500 Index. As most investors know, that period encompassed much of the technology and telecom bubble that peaked during the late 1990s. In fact, toward the end of the decade, technology and telecom combined accounted for approximately 40% of the S&P 500's market capitalization, and the benchmark's performance was primarily driven by its largest and most overvalued stocks. Given the index characteristics described above numerous active managers perceived the benchmark as excessively risky both in terms of sector concentration and valuation; as such they generally stayed away from the securities at the center of the bubble and thus relative performance was adversely affected. In contrast, when the technology and telecom bubble burst at the beginning of 2000, the relative performance of active managers improved dramatically as many avoided the most speculative areas of the market during the previous run up. Consequently, during the 5-year period ending 9/30/04 over 90% of top quartile active share large cap core non-index mutual funds outperformed the S&P 500 Index. Additionally, even though the median top quartile active share large cap core mutual fund underperformed the S&P 500 Index by approximately -6.5%, annualized over the five year period from 4/95 – 3/00 , performance in the subsequent five year period (4/00 - 3/05) exceeded the benchmark by 7.3%, annualized.

The Importance of the Market Environment

While the analysis on the previous page appears to provide support that truly active managers can generate superior long term results, it is evident that relative performance over rolling five year periods exhibits considerable volatility and can be meaningfully impacted by the market environment. Most notably, the relative performance of equity managers versus the broad market appears to be dependent on the absolute level of market returns. In general, even proponents of passive management concede that active managers generally provide superior downside protection relative to the benchmark during bear market time periods, however they argue that those same managers are unable to keep up with the benchmark during bull market environments and thus exhibit inferior long-term results.

The tables below appear to provide support for this hypothesis. During the three previous bear market time periods, the median U.S. large cap core non-index equity mutual fund does appear to provide superior downside protection relative to the benchmark. Likewise, the median fund trails the benchmark in each of the three previous bull market time periods. However, the results are considerably more encouraging when analyzing mutual funds with top quartile active shares. High active share mutual funds appear to provide superior downside protection during bear market time periods relative to their benchmark and their peers (i.e., the median manager), while also posting competitive and often above benchmark returns during bull market time periods. In fact, the median top quartile active share large cap core mutual fund outperformed the benchmark in two of the last three bull markets, on a net-of-fees basis, while posting absolute returns of approximately 16% during the lone bull market environment where relative performance was inferior. It should also be noted that the performance of mutual funds with bottom quartile active shares was inferior to that of the median fund in all three bear market time periods and in two of three bull market time periods.

Performance of U.S. Large Cap Core Non-Index Mutual Funds over Bull and Bear Market Time Periods

	Bear Market Time Periods					
Time Period	**10/87 - 12/87**	**# Funds**	**4/00 - 9/02**	**# Funds**	**11/07 - 2/09**	**# Funds**
Performance of Median U.S. Large Cap Core Non-Index Fund	-20.86	95	-16.88	291	-40.30	488
S&P 500 Performance	-22.53	--	-20.56	--	-41.39	--
Median Performance of Funds with Top Quartile Active Share	-20.22	24	-9.19	73	-40.10	122
Median Performance of Funds with Bottom Quartile Active Share	-21.19	24	-20.19	73	-40.73	122

	Bull Market Time Periods					
Time Period	**1/88 - 3/00**	**# Funds**	**10/02 - 10/07**	**# Funds**	**3/09 - 4/10**	**# Funds**
Performance of Median U.S. Large Cap Core Non-Index Fund	16.75	99	15.04	354	51.70	524
S&P 500 Performance	18.94	--	15.54	--	53.97	--
Median Performance of Funds with Top Quartile Active Share	15.61	25	16.53	89	56.01	131
Median Performance of Funds with Bottom Quartile Active Share	17.58	25	14.31	89	51.05	131

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Since the market environment appears to have a meaningful impact on the relative performance of active managers, Manning & Napier believes that a market cycle time period is preferable for performance measurement relative to fixed calendar year time periods. As the market cycle includes both bull and bear market environments it helps "level the playing field" by reducing some of the biases of a bull market or bear market dominated calendar year or trailing time period. Additionally, the table below illustrates that top quartile active share large cap core mutual funds have faired well versus the S&P 500 Index over multiple market cycles. For example, if market cycles are measured from "trough-to-trough" (i.e., from the end of one bear market to the next), the median top quartile active share fund has outperformed the S&P 500 Index in all three market cycles since 1/88. If market cycles are measured from "peak-to-peak" (i.e. from the end of one bull market to the next) the median top quartile active share fund outperformed the S&P 500 Index in 2 of the 3 market cycles, while posting absolute returns of approximately 13.5%, annualized, during the market cycle where relative performance was inferior. In contrast, while the median U.S. large cap core non-index equity mutual fund marginally outperformed the S&P 500 Index in two of three market cycles when measured from "peak-to-peak", performance was below that of the index in all three market cycle time periods when measured from "trough-to-trough". Lastly, the market cycle performance of low active share managers was even less impressive, trailing the S&P 500 Index in all three market cycles when measured from "trough-to-trough" and in two of three market cycles when measured from "peak-to-peak". Overall, taking into account all six market cycles listed in the table below, the median top quartile active share large cap core mutual fund captured, on average, 100% of the S&P 500 Index's upside return while capturing only 94% of its downside return. Comparatively, the median non-index large cap core mutual fund captured on average 96% of the benchmark's upside return while capturing 97% of its downside return. The upside/downside market capture for low active share (i.e., bottom quartile active share) funds was 96% and 99%, respectively.

Performance of U.S. Large Cap Core Non-Index Mutual Funds over Market Cycle Time Periods

	Market Cycle Time Periods Trough-to-Trough					
Time Period	**1/88 - 9/02**	**# Funds**	**10/02 - 2/09**	**# Funds**	**3/09 - 4/10**	**# Funds**
Median Performance of Funds with Top Quartile Active Share	11.08	25	1.23	89	56.01	131
Performance of Median U.S. Large Cap Core Non-Index Fund	10.37	99	0.29	354	51.70	524
Median Performance of Funds with below Average Active Share	10.32	52	-0.06	172	51.27	238
S&P 500 Performance	11.07	--	0.34	--	53.97	--

	Market Cycle Time Periods Peak-to-Peak					
Time Period	**10/87 - 3/00**	**# Funds**	**4/00 - 10/07**	**# Funds**	**11/07 - 4/10**	**# Funds**
Median Performance of Funds with Top Quartile Active Share	13.47	24	7.30	73	-7.32	122
Performance of Median U.S. Large Cap Core Non-Index Fund	14.41	95	3.17	291	-7.66	488
Median Performance of Funds with below Average Active Share	14.41	49	1.98	146	-7.89	225
S&P 500 Performance	16.13	--	2.12	--	-8.01	--

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Conclusion

While the debate regarding the merits of active versus passive management is likely to rage on, the above analysis highlights several important factors that we believe investors should consider when evaluating the relative performance of active managers. Even though, numerous investment managers purport to implement an active investment approach, utilizing active share to evaluate the similarities between a manager's portfolio and their benchmark from a holdings perspective, may help investors differentiate between truly active managers and closet indexers. Additionally, while the performance of the median or average manager versus the benchmark does not generally appear impressive, relative performance of truly active managers (i.e., those with high active share) appears attractive over a variety of market environments. Lastly, we believe investors should recognize that market conditions may have a meaningful impact on the relative performance of active managers and should thus evaluate managers over a full market cycle which includes both bull and bear market time periods.

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