Nomura Securities International Inc, New York
Global Quantitative Research

NOMURA

Quant Alpha

Paradigm in motion

15 June 2010

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Nomura Securities International, Inc.

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Please read the analyst certifications and important disclosures on pp. 31–32. gl

Paradigm in motion

- **Factor failure** – momentum, earnings quality, value

  and the regime change of 2000
- **Systemic risk** – diversification challenge and the

  regime change of 2000
- **Diversity of factors** - granularity

  factor nuance vs. factor category

  key feature of the *Alpha Repair* framework

Factor failure –

momentum, earnings quality, value

and the regime change of 2000

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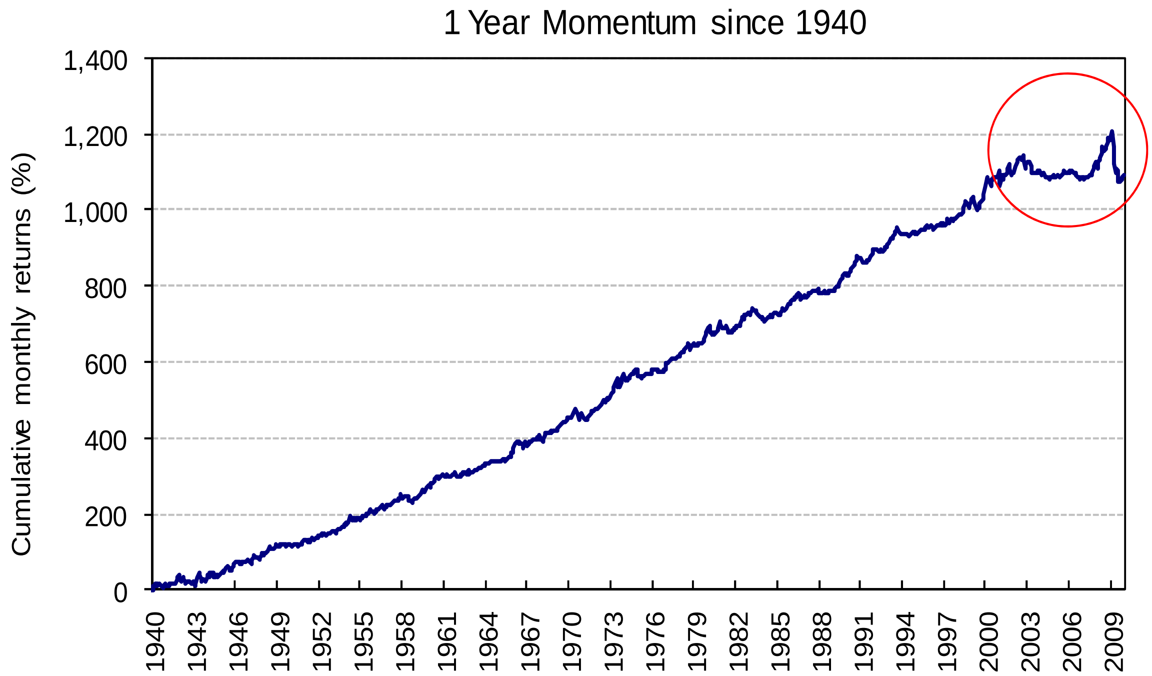
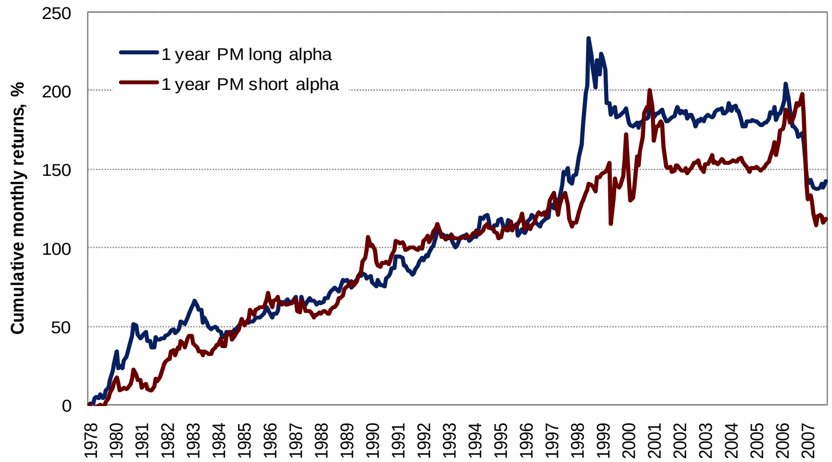
Momentum worked consistently for sixty years, and then …

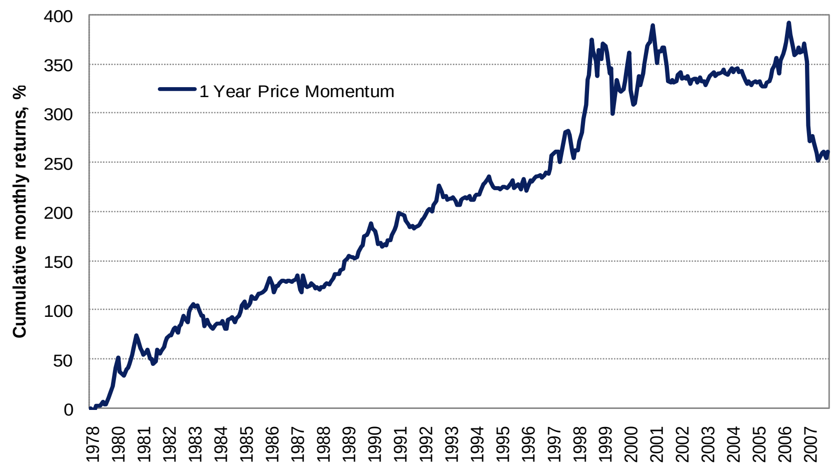


Note: Cumulative monthly factor returns to 12-month momentum (decile spreads) since 1940. The portfolios are constructed monthly using NYSE prior (2-12) return decile breakpoints. Universe is all NYSE, AMEX, and NASDAQ stocks. Analysis based on data from January 1940 to December 2009. Transaction costs not considered.
Source: Kenneth R. French's website (http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html, Nomura Securities International Inc.

Is price momentum permanently damaged?

long and short alpha (top), factor return (bottom)





Note: Based on one-year price momentum (last twelve months' returns minus last month's). Top panel shows long-side alpha (blue line, return of the highest-ranked decile minus the return of the market, Russell 1000) and short-side alpha (red line, market return minus the lowest-ranked decile return). Bottom panel shows the factor return of one-year price momentum (long-side alpha plus short alpha), excluding transaction costs. Universe is Russell 1000. Last data as of 2/28/2010.

Source: Nomura Securities International Inc., Compustat, I/B/E/S, Russell, and IDC.

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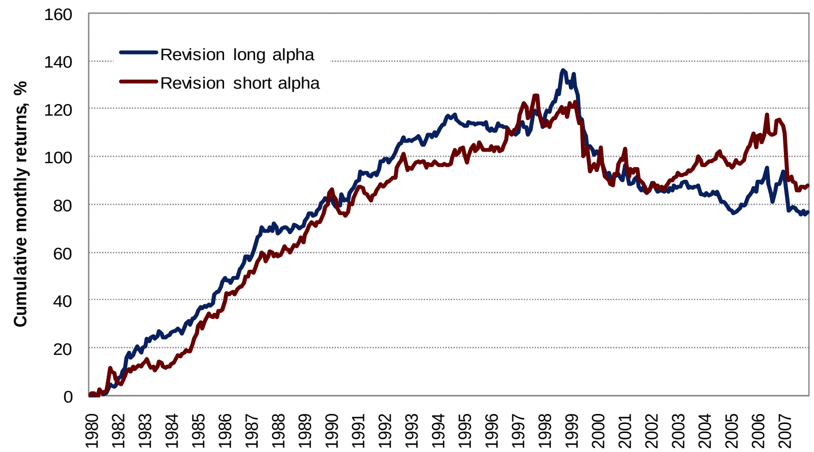
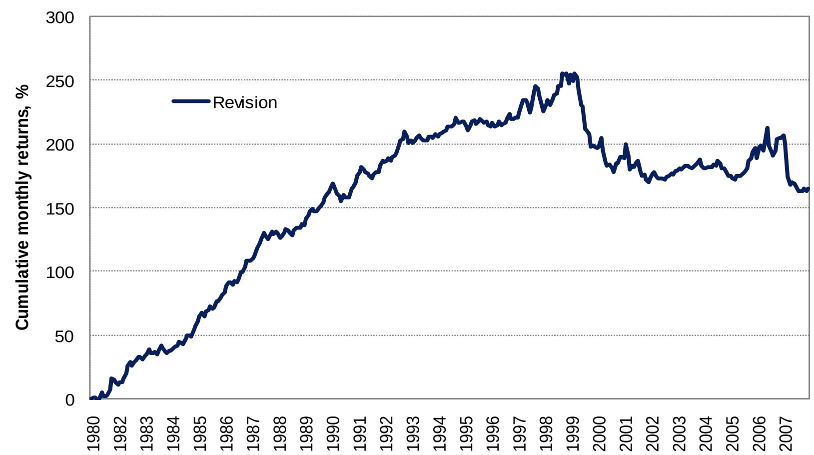
Impact of estimate revisions diminished due to Reg FD

long and short alpha (top), factor return (bottom)



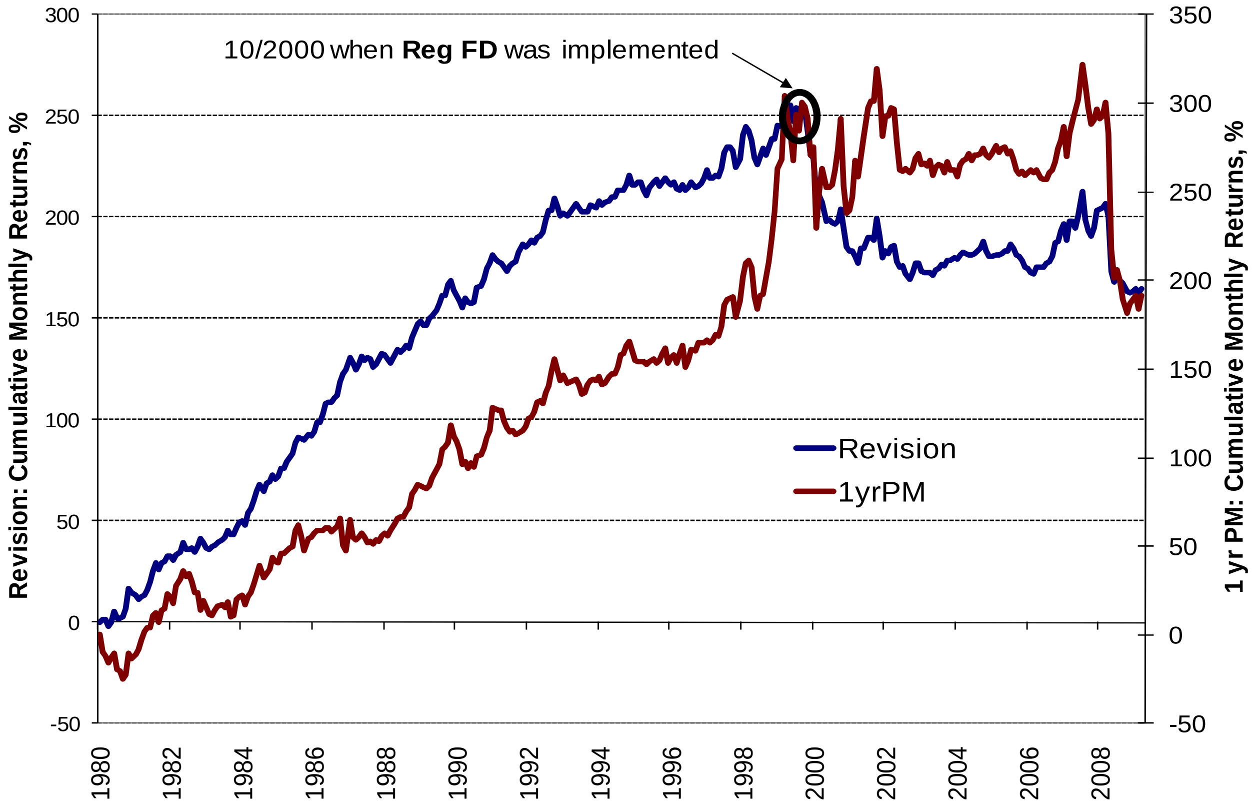


Note: Based on analyst up down revisions (number of FY1 I/B/E/S up estimates minus number of down estimates divided by total number of estimates). Top panel shows long-side alpha (blue line, return of the highest-ranked decile minus the return of the market, Russell 1000) and short-side alpha (red line, market return minus the lowest-ranked decile return). Bottom panel shows the factor return of up down revisions (long-side alpha plus short alpha). Transaction costs are not considered. Universe is Russell 1000. Last data as of 2/28/2010.

Source: Nomura Securities International Inc., Compustat, I/B/E/S, Russell, and IDC.

The world changed around 2000

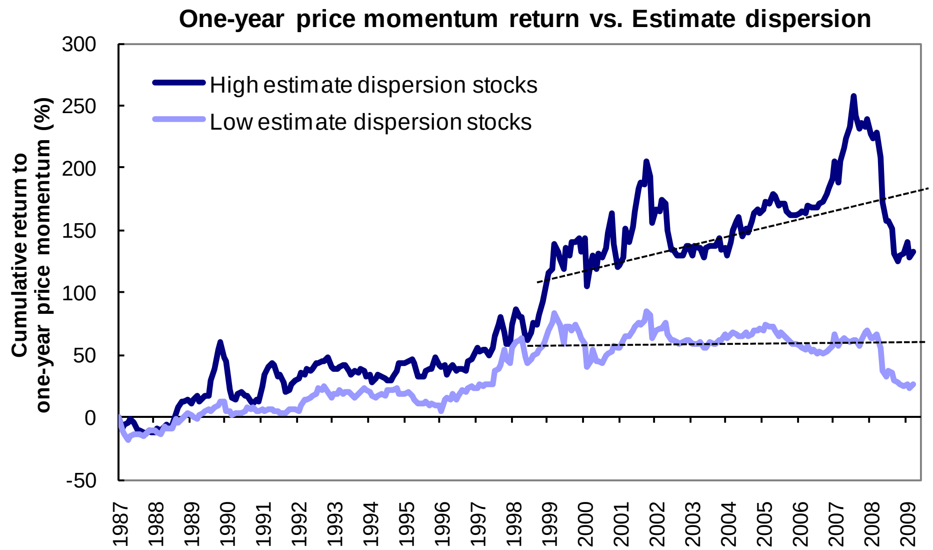
The momentum-revisions coupling conundrum

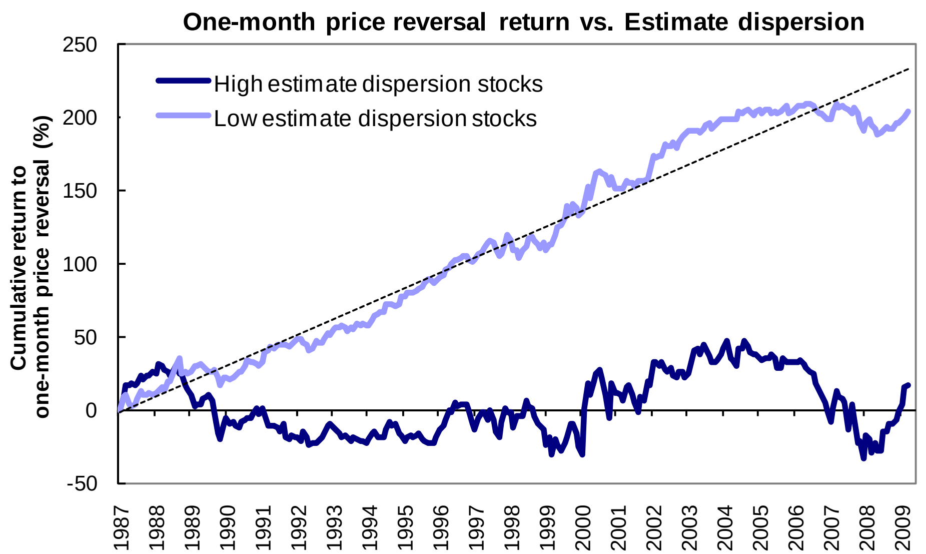


Note: Shows returns to analyst up down revisions (blue line, number of FY1 I/B/E/S up estimates minus down estimates divided by total number of estimates) and returns to one-year price momentum (red line, last twelve months' returns minus last month's). Universe is Russell 1000. Last data as of 2/28/2010. Transaction costs are not considered.

Source: Nomura Securities International Inc., Russell, IDC.

Price momentum and price reversal
— the contrasting roles of estimate dispersion





Note: Universe is S&P500. Upper chart shows the cumulative monthly return (quintile spread) to one-year price momentum (excluding the most recent month) in top and bottom third groups categorized by the dispersion of analyst estimates for current-year earnings. Lower chart shows the cumulative monthly return (quintile spread) to one-month price reversal in top and bottom third groups categorized by the dispersion of analyst estimates for current-year earnings. Period of analysis is from January 1988 through February 2010. Transaction costs are not considered.

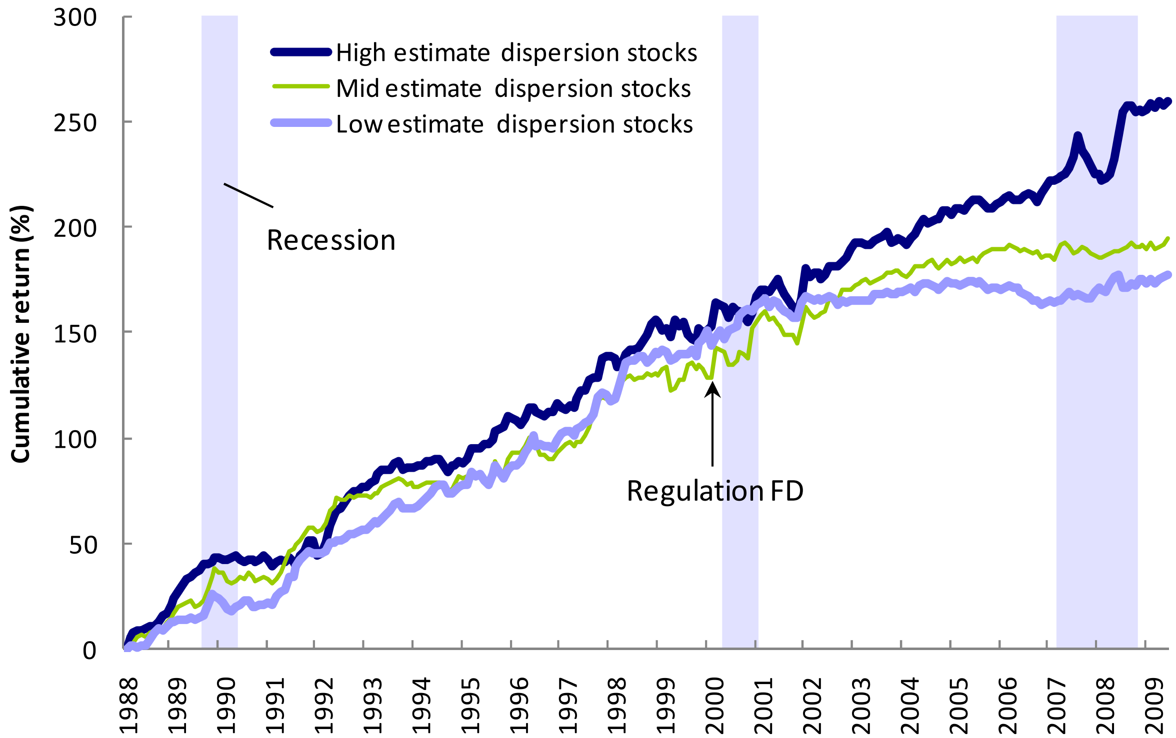
Source: Nomura Securities International Inc., Compustat, I/B/E/S, IDC, S&P.

Factor failure –

momentum, **earnings quality**, value

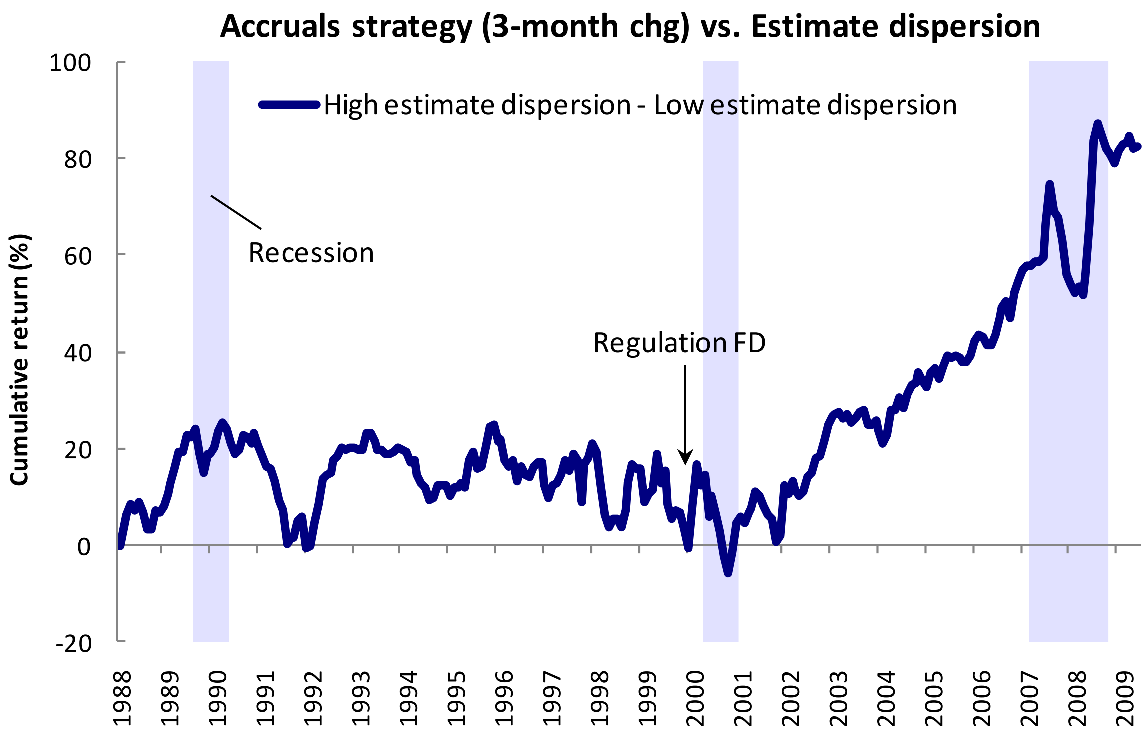
and the regime change of 2000

Accruals work for high estimate dispersion stocks — embrace controversy



Note: Universe is Russell 3000. Shows cumulative monthly returns to accruals (equally weighted quintile spread) in each of three groups categorized by level of dispersion of analyst estimates for current-year earnings (deflated by the absolute value of mean estimate). Accruals are based on Sloan's (1996) definition using three-month change in trailing four-quarter average in financial statements, not using 12-month change in annual financial statements as Sloan originally used. Period of analysis is from January 1989 through April 2010. Transaction costs are not considered.
Source: Nomura Securities International Inc., Compustat, IDC, Russell, I/B/E/S, NBER.

Advantage of high estimate dispersion for accruals



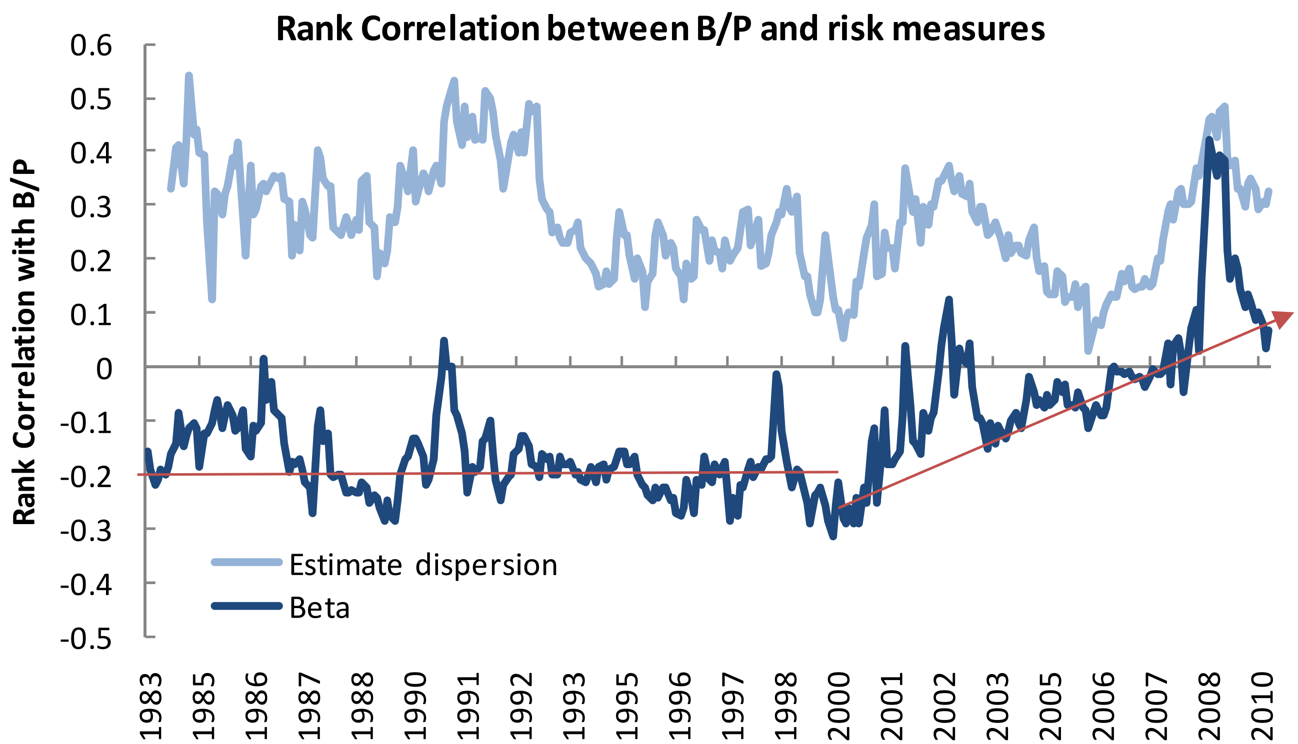
Notes: Universe is Russell 3000. Shows the spread of cumulative monthly returns to three-month change in accruals (equally weighted quintile spread) between top and bottom third groups categorized by level of dispersion of analyst estimates for current-year earnings (deflated by the absolute value of mean estimate). Accruals are based on Sloan's (1996) definition using three-month change in trailing four-quarter average in financial statements, not using 12-month change in annual financial statements as Sloan originally used. Period of analysis is from January 1989 through April 2010. Transaction costs are not considered.
Source: Nomura Securities International Inc., Compustat, IDC, Russell, I/B/E/S, NBER.

Factor failure –

momentum, earnings quality, **value**

and the regime change of 2000

A regime shift in market risk of B/P over the last decade?



Note: Shows a history of rank correlation between B/P and risk factors (estimate dispersion and beta). Universe is Russell 1000. Period of analysis is from November 1983 through May 2010.

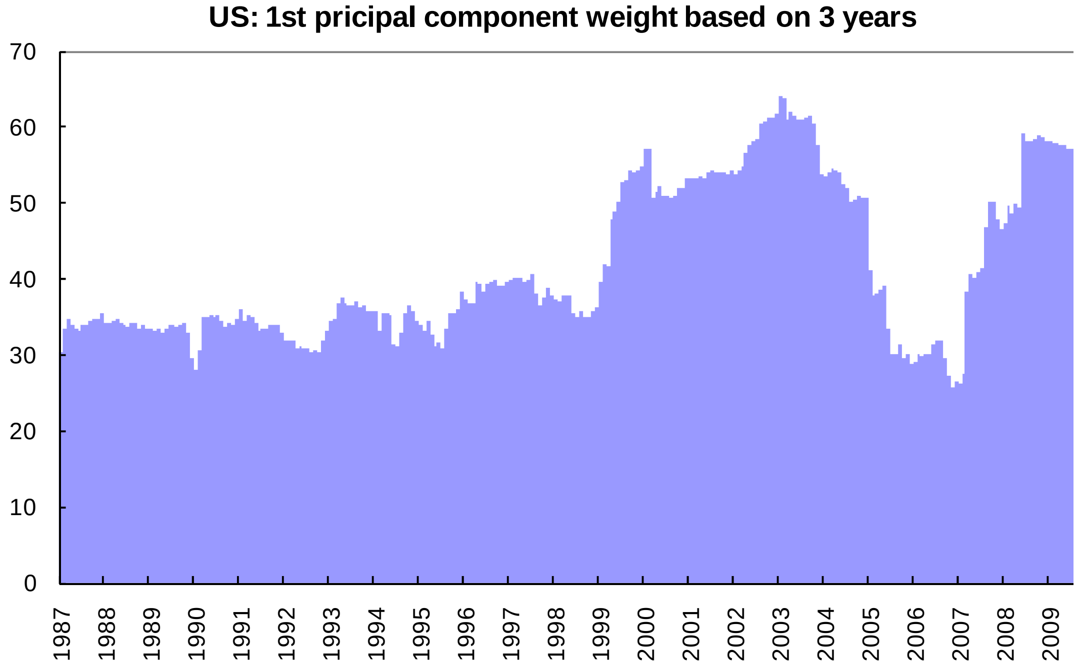
Source: Nomura Securities International Inc., Compustat, I/B/E/S, Russell, and IDC.

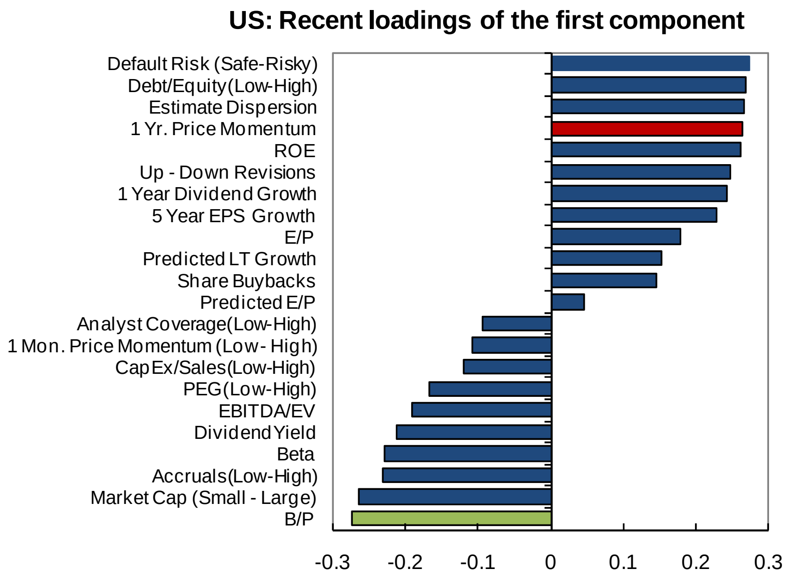
Systemic risk –

diversification challenge and the regime change of 2000

Are multifactor models really multifactor?

How much is explained by a single factor?





Note: Weights of the first principal component in the factor-return variance are shown in time series on the left side. The principal component analysis is based on the past three-year performances of 22 representative factors. The bar charts on the right side show the latest loadings of the factors that produce the primary, first principal component based on the last three years. Universe is Russell 1000. Period of analysis is from November 1987 through May 2010.

Source: Nomura Securities International Inc., Compustat, I/B/E/S, IDC, Russell.

Factor returns & ranks: April - May 2010

Factor	Returns: Apr 1 - 15	Returns: Apr16-May7	Returns: May 10-12	Ranks: Apr 1 - 15	Ranks: Apr16-May7	Ranks: May 10-12
EBIT/WCPPE	-6.1	8.5	-2.2	52	1	38
Dividend Yield	-2.4	7.6	-3.4	35	2	47
EBIT/Price	-3.4	6.7	-2.4	39	3	40
ROIC	-4.7	5.6	-2.9	47	4	45
ROA	-4.7	5.6	-2.8	48	5	44

Factor	Returns: Apr 1 - 15	Returns: Apr16-May7	Returns: May 10-12	Ranks: Apr 1 - 15	Ranks: Apr16-May7	Ranks: May 10-12
Op Inc. Variability	0.5	-4.1	2.4	21	46	6
Predicted LT Grow	-0.9	-4.1	1.2	25	47	14
1 Year Price Mome	4.1	-4.7	4.7	6	48	1
Beta	9.2	-4.8	3.6	1	49	2
Predicted 1-Year EI	0.7	-5.4	1.7	20	50	10
EPS Variability	5.9	-6.4	3.4	3	51	4
Default Risk	5.9	-7.8	3.5	4	52	3

Factor	Returns: Apr 1 - 15	Returns: Apr16-May7	Returns: May 10-12	Ranks: Apr 1 - 15	Ranks: Apr16-May7	Ranks: May 10-12
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ROA	-4.7	5.6	-2.8	48	5	44
EBIT/EV	-5.6	5.3	-3.0	51	6	46
Dividend Yield + Share Buy Backs	-4.6	4.7	-2.2	46	7	37
Share Buybacks	-3.8	3.6	-1.8	41	8	34
Dividend Payout Ratio	0.7	3.3	0.5	19	9	19
E/P	-5.0	3.3	-4.4	49	10	52
ROE	-5.4	3.0	-3.6	50	11	48
EBITDA/Price	-1.3	2.7	-1.5	28	12	31
EBITDA/EV	-3.9	2.2	-2.6	42	13	43
Sales/Employee	-2.5	2.1	-1.1	36	14	29
ROIC x B/P	-4.1	2.1	-2.6	45	15	42
Operating Leverage	-1.1	1.8	0.2	26	16	21
1 Mon. Price Reversal	-4.0	1.6	-3.7	44	17	49
Stable Growth	-3.8	1.5	-2.5	40	18	41
Asset Turnover	-2.0	1.5	-0.3	31	19	26
5 Year Dividend Growth	-3.9	1.3	-3.8	43	20	50
Sales Growth	-2.5	1.1	-1.6	37	21	33
B/P (ex goodwill)	2.0	1.0	1.5	15	22	11
1 Year EPS Growth	-2.4	0.8	-1.3	34	23	30
1 Year Dividend Growth	-2.2	0.7	-1.5	32	24	32
Cash Flow/EV	-1.4	0.1	-0.9	29	25	27
5 Year EPS Growth	-1.7	0.0	-2.0	30	26	35
Inventory Turnover	3.9	0.0	0.8	8	27	17
Debt/Equity	2.1	-0.1	0.7	14	28	18
R&D/EV	3.5	-0.5	0.9	9	29	16
Gross Margin	-2.2	-0.8	-1.1	33	30	28
R&D/Sales	3.0	-1.1	1.3	10	31	13
Estimate Dispersion	5.8	-1.2	2.4	5	32	7
Predicted E/P	-3.3	-1.3	-4.1	38	33	51
Sales/Price	0.9	-1.5	-0.2	17	34	24
Earnings Quality (Accruals)	4.0	-1.9	1.7	7	35	9
CapEx/Assets	2.2	-2.3	0.2	13	36	22
CapEx/Sales	2.4	-2.4	-0.3	12	37	25
B/P	2.5	-2.5	0.4	11	38	20
Sales Variability	1.8	-2.6	1.5	16	39	12
PEG	-0.7	-2.8	-2.0	24	40	36
PEGY	-1.3	-3.0	-2.3	27	41	39
Up to Down Revisions	-0.6	-3.1	2.0	23	42	8
Cash/Sales	0.1	-3.2	1.0	22	43	15
Analyst Coverage	0.7	-3.4	0.1	18	44	23
Market Cap (Small vs Large)	6.2	-3.5	2.8	2	45	5
Op Inc. Variability	0.5	-4.1	2.4	21	46	6
Predicted LT Growth	-0.9	-4.1	1.2	25	47	14
1 Year Price Momentum	4.1	-4.7	4.7	6	48	1
Beta	9.2	-4.8	3.6	1	49	2
Predicted 1-Year EPS Growth	0.7	-5.4	1.7	20	50	10
EPS Variability	5.9	-6.4	3.4	3	51	4
Default Risk	5.9	-7.8	3.5	4	52	3

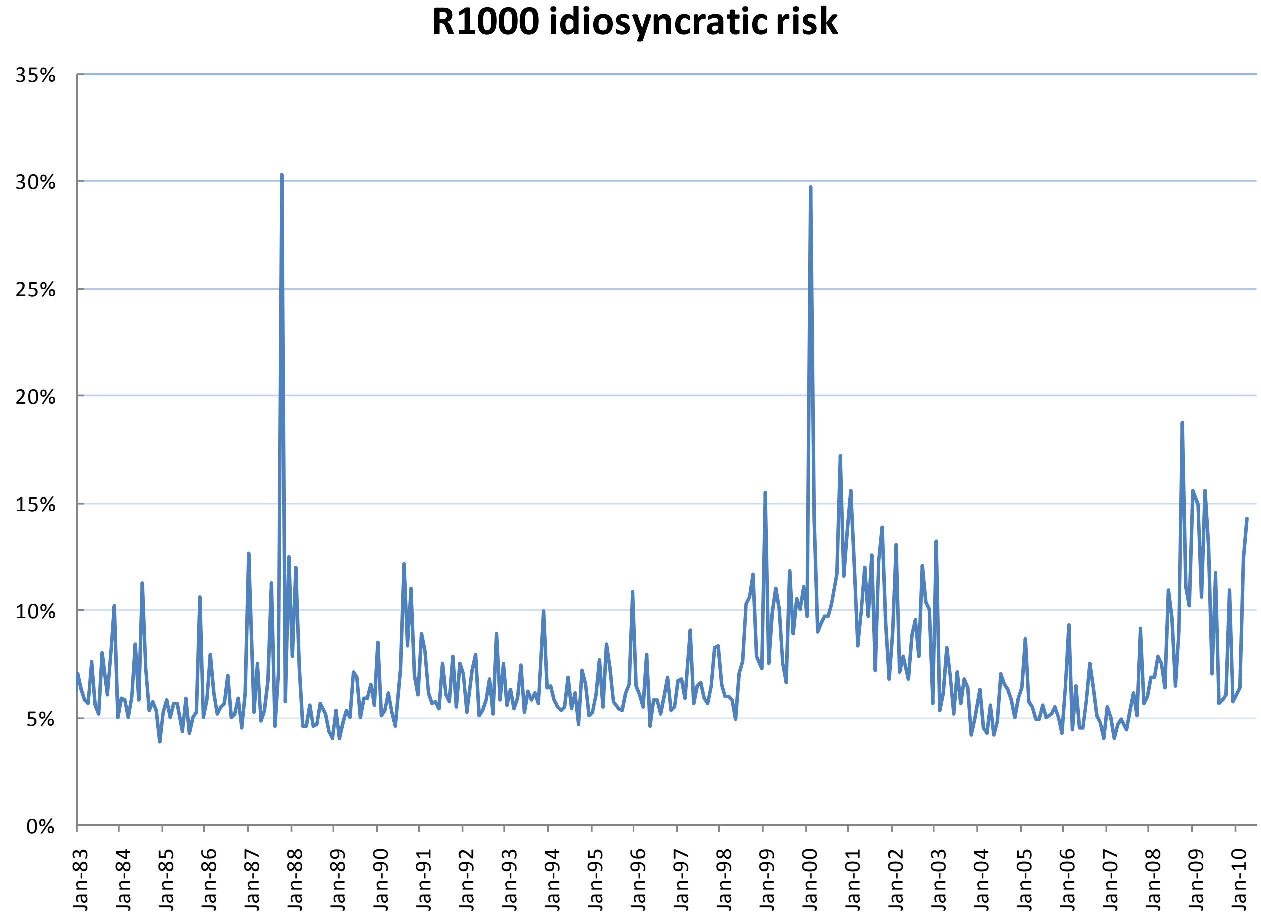
Note: Universe is Russell 1000. Factor return is defined as decile spread based on each factor (rebalanced monthly). Yellow and blue highlights indicate top and bottom 10 ranked strategies, respectively. Factor returns do not include transaction costs. Periods of analysis are between 1 April 2010 and 12 May 2010.
Source: Nomura Securities International Inc., Compustat, I/B/E/S, Russell, and IDC.

Systemic risk –

diversification challenge and the regime change of 2000

The pivotal role of risk

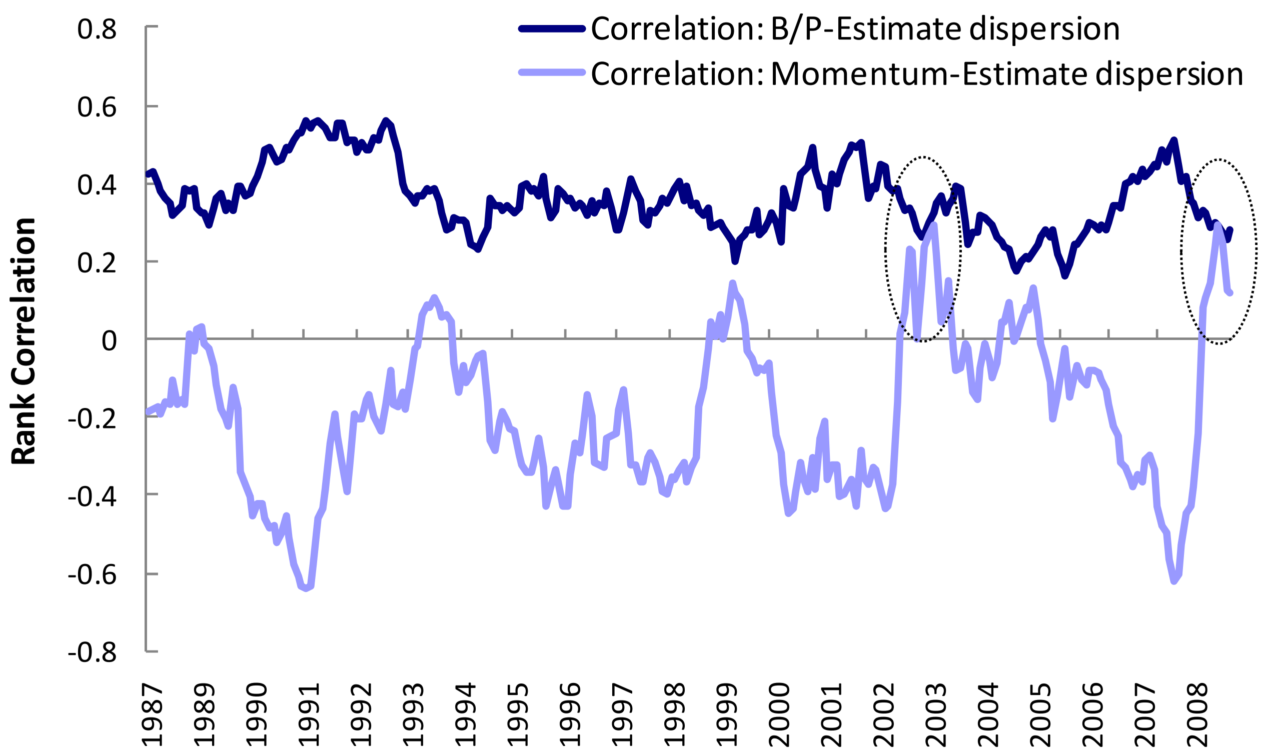
Bouts of high idiosyncratic risk



Note: Chart shows average idiosyncratic return for stocks in Russell 1000 index. Individual stock's idiosyncratic return is calculated by subtracting return contributions due to exposures to 17 quantitative factors from stock's total realized return. The seventeen factors include one-month price reversal, one-year dividend growth, one-year price momentum, five-year EPS growth, analyst coverage, B/P, capex/sales, dividend yield, E/P, earnings quality (accruals), EBITDA/EV, PEG, predicted E/P, predicted long-term growth, ROE, share buybacks, up-to-down revisions. Period of analysis is from January 1983 through April 2010.
Source: Nomura Securities International Inc., Dow Jones, Bloomberg, Compustat, I/B/E/S, IDC, Russell.

B/P & momentum & earnings risk

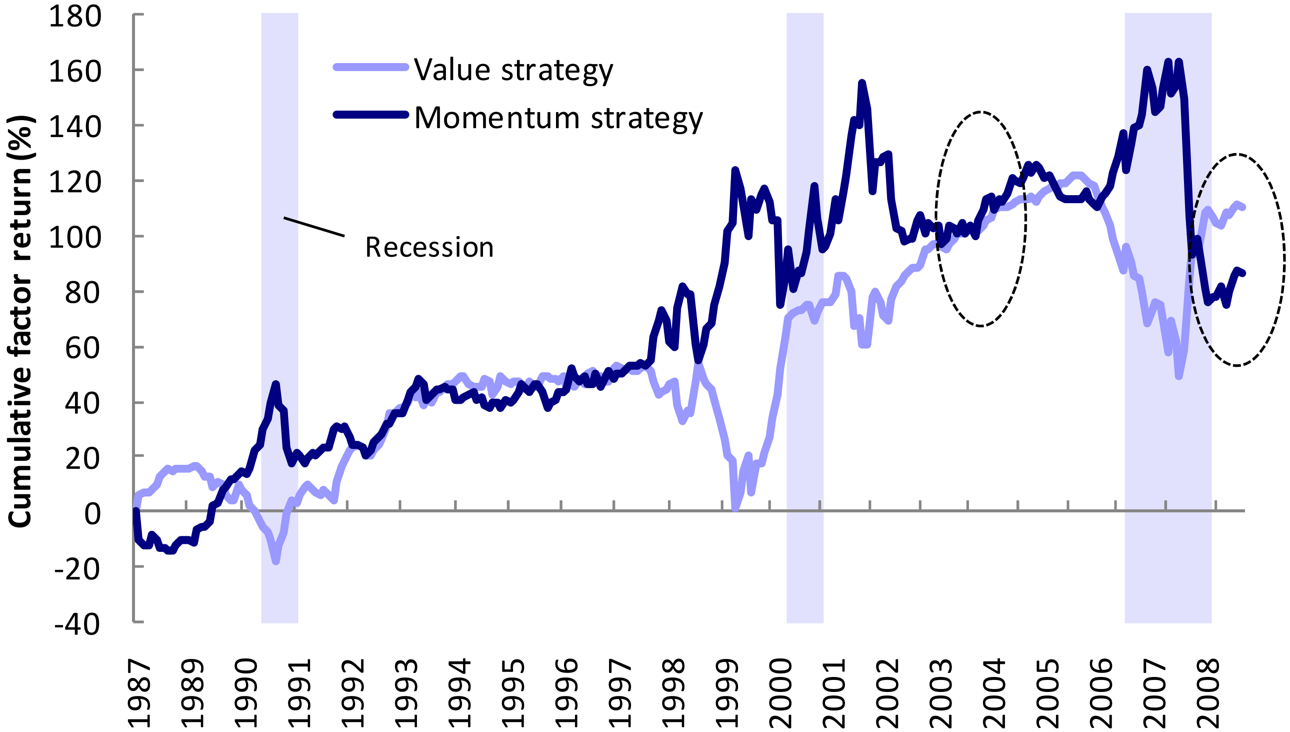
Why value & momentum (usually) diversify



Note: B/P and one-year price momentum vs. estimate dispersion rank correlation are based on the B/P and one-year price momentum scores and estimate dispersion (FY1) in the S&P500 universe. Last data as of 31 May 2010.

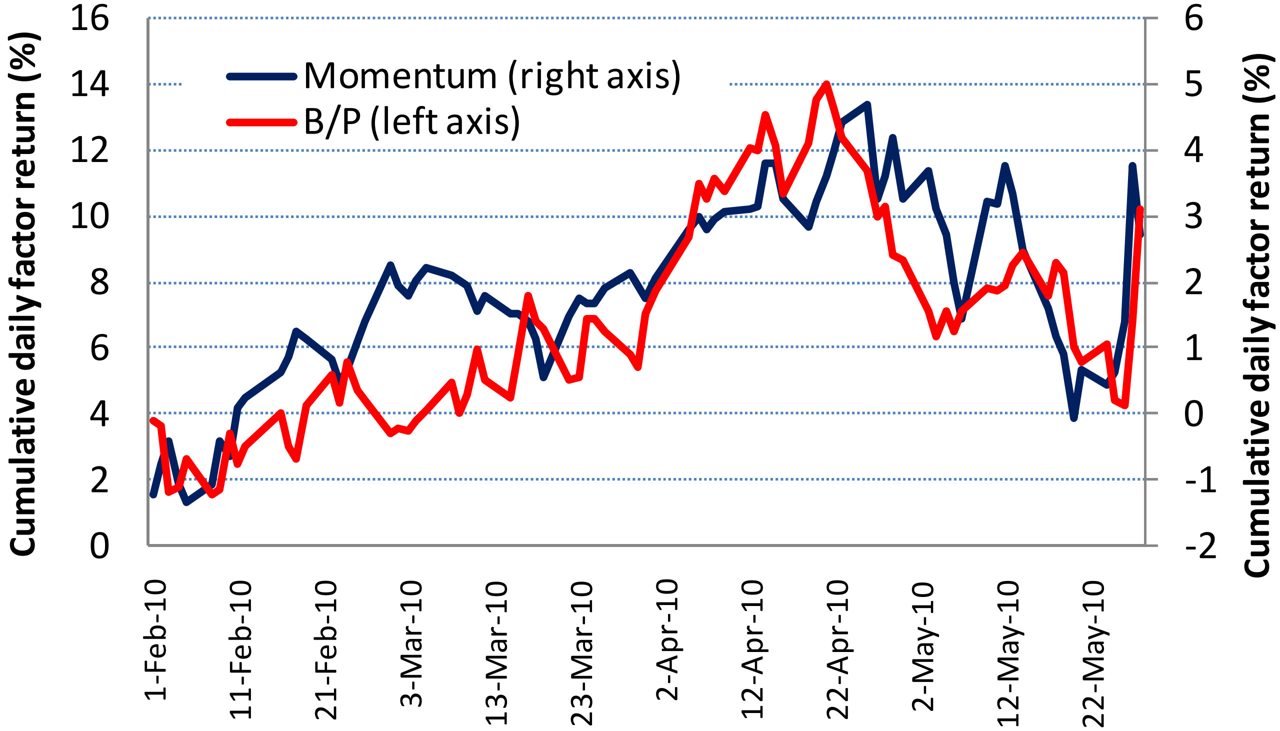
Source: Nomura Securities International Inc., S&P, Compustat, I/B/E/S.

B/P & momentum trade ahead
WHO WINS?



Note: Universe is S&P500. Chart shows the cumulative monthly returns (quintile spread) to momentum strategy (1yr price momentum, dark blue) and value strategy (B/P, light blue) in the universe. Period of analysis is from January 1988 through May 2010. Transaction costs are not considered.
Source: Nomura Securities International Inc., Compustat, I/B/E/S, S&P, MSCI and IDC.

B/P & momentum move together now!



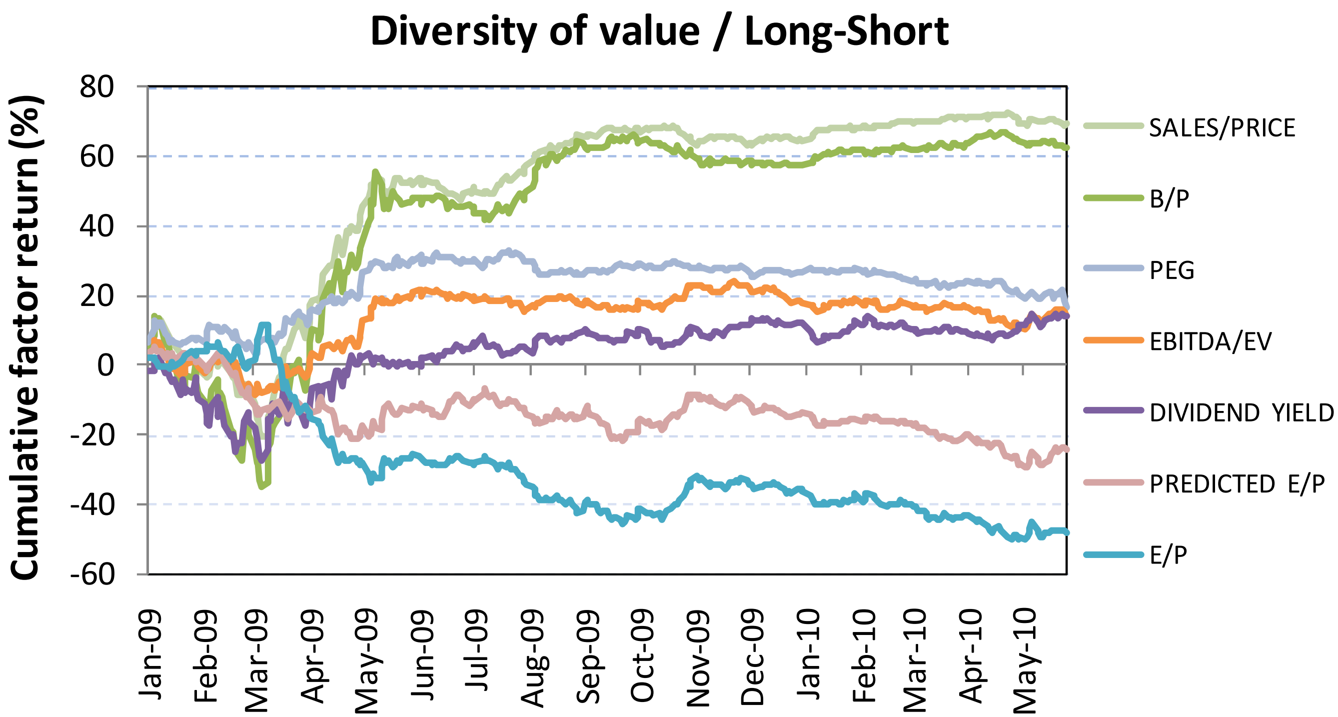
Note: Universe is Russell 1000. Chart shows the cumulative daily returns (decile spread) to momentum strategy (one-year price momentum, dark blue) and value strategy (B/P, red) in the universe. Period of analysis is from 1 February 2010 through 28 May 2010. Transaction costs are not considered.
Source: Nomura Securities International Inc., Compustat, Russell, and IDC.

**Diversity of factors - **granularity

factor nuance vs. factor category

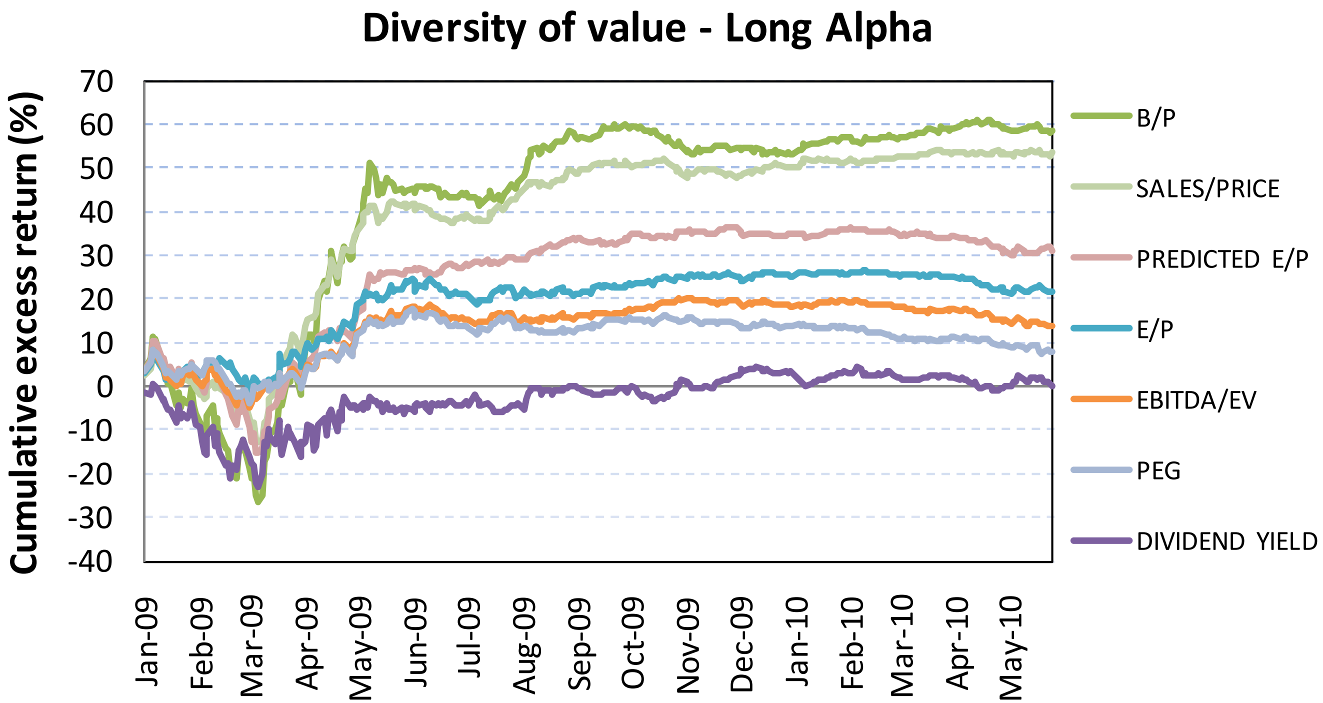
the heart of the *Alpha Repair* framework

How should you own value?



Note: Universe is Russell 1000. Chart shows cumulative daily factor returns for value strategies (decile spread). Transaction costs are not considered. Period of analysis is from 1/2/2009 through 5/26/2010.
Source: Nomura Securities International, Inc., Compustat, Russell and IDC.

How should you own value?



Note: Universe is Russell 1000. Chart shows cumulative daily excess returns to the long portfolio (top decile) for value strategies. Transaction costs are not considered. Period of analysis is from 1/2/2009 through 5/26/2010.
Source: Nomura Securities International Inc., Compustat, Russell and IDC.

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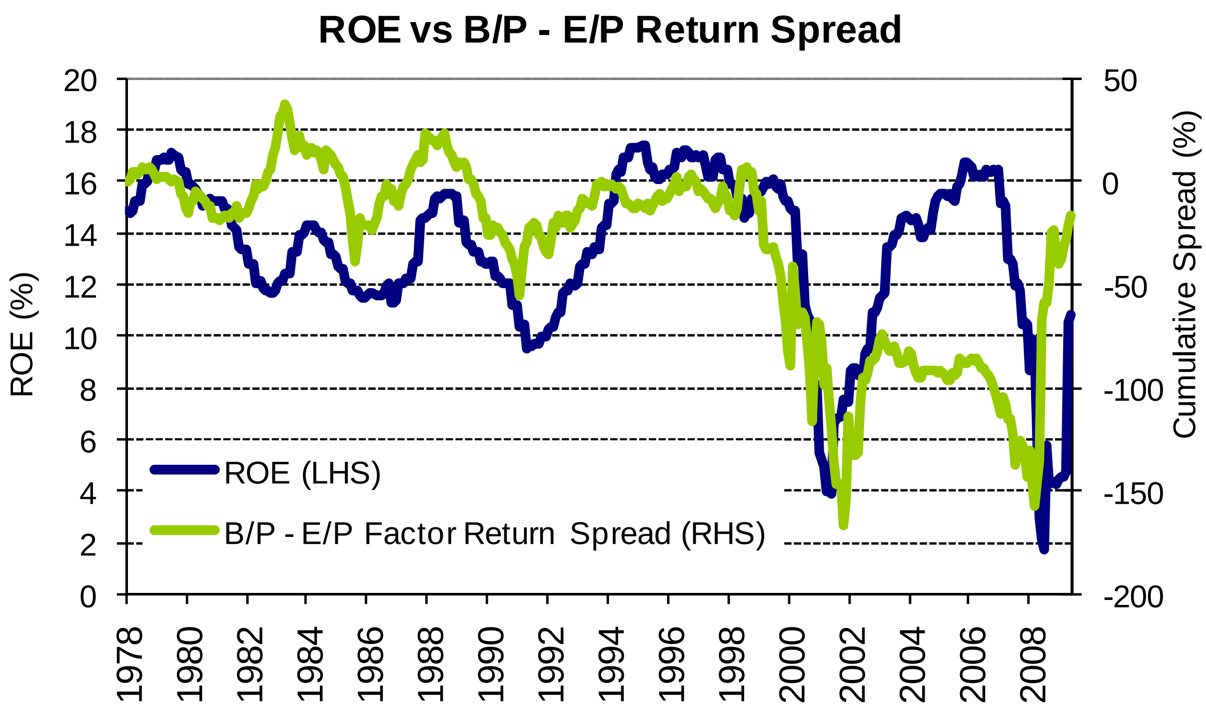
How should you own value?

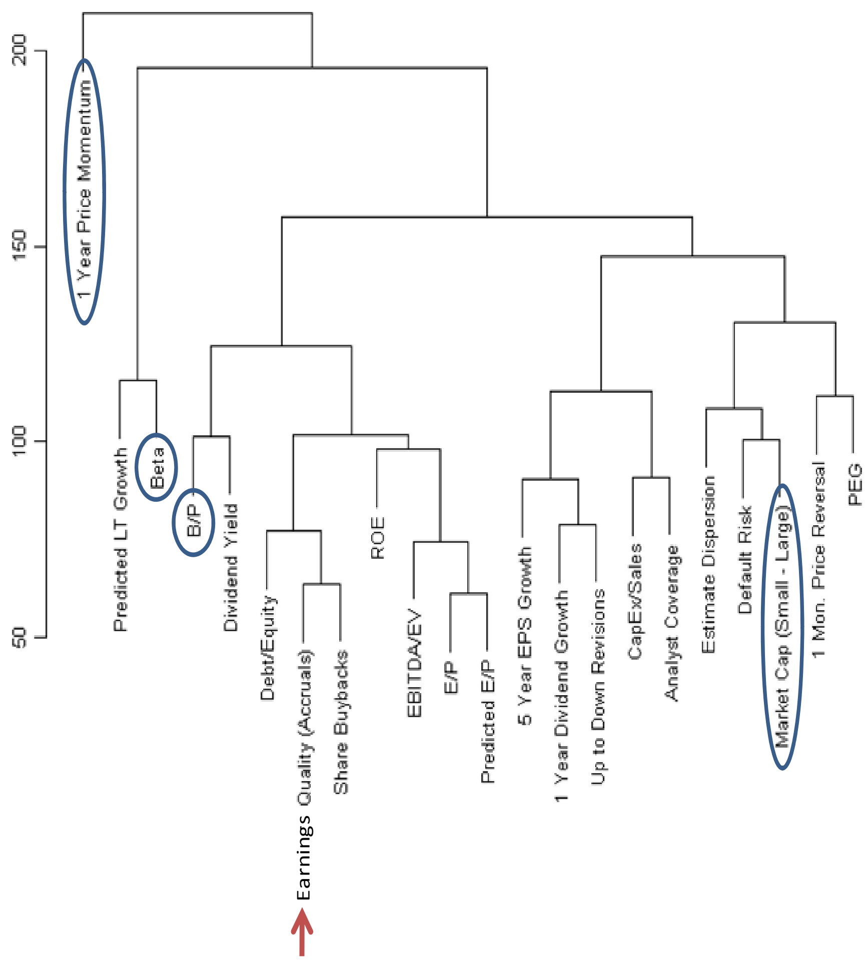


Note: Shows aggregate ROE for the Russell 1000 Index (blue line) and the cumulative factor return spread of B/P and E/P (green line) in the Russell 1000. Period of analysis is from January 1979 through May 2010. Transaction costs are not considered.

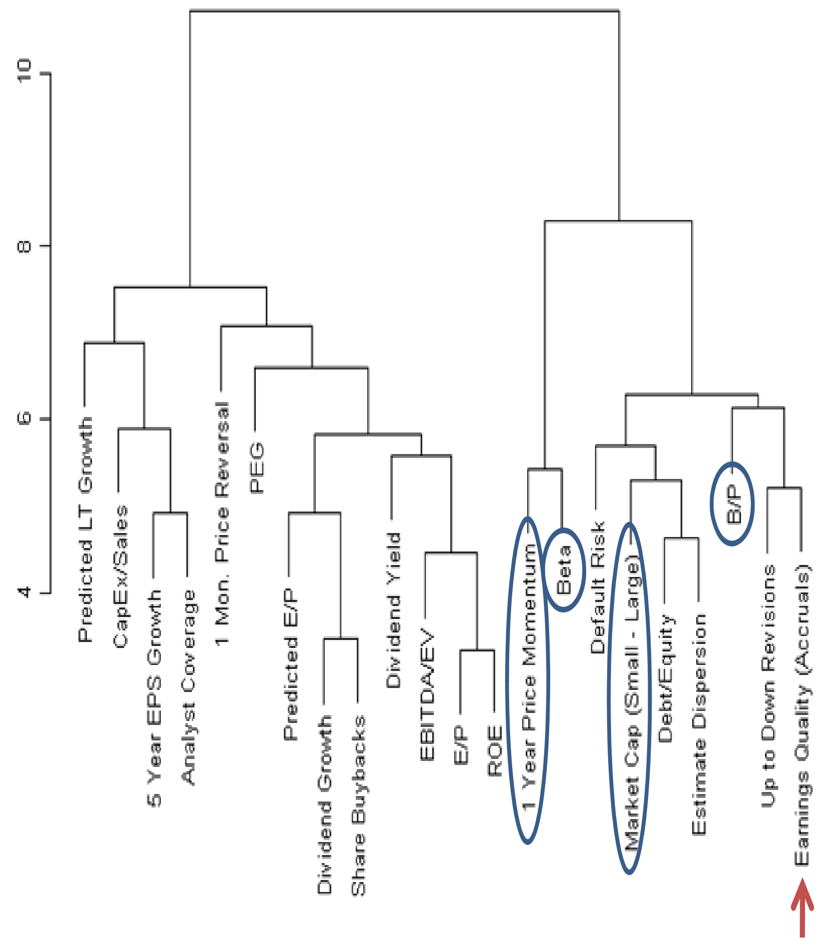
Source: Nomura Securities International Inc., Compustat, Russell, and IDC.

Clustering of factors – much has changed

January 1980 – May 2010



March 2010 – May 2010



Note: We applied hierarchical cluster analysis to monthly factor returns in the Russell 1000 from January 1980 through May 2010 in the left side chart and daily factor returns from March 2010 through May 2010 in the right side chart. A close pair of clusters is grouped based on “distance” between clusters, which is defined as the average Euclidean distance for every pair in each cluster (average linkage method). Monthly and daily factor returns are based on decile spreads. Transaction costs are not considered.

Source: Nomura Securities International Inc., I/B/E/S, Russell, Compustat, IDC.

Now here's an idea

Adaptive strategy selection: the ***Alpha Repair*** framework

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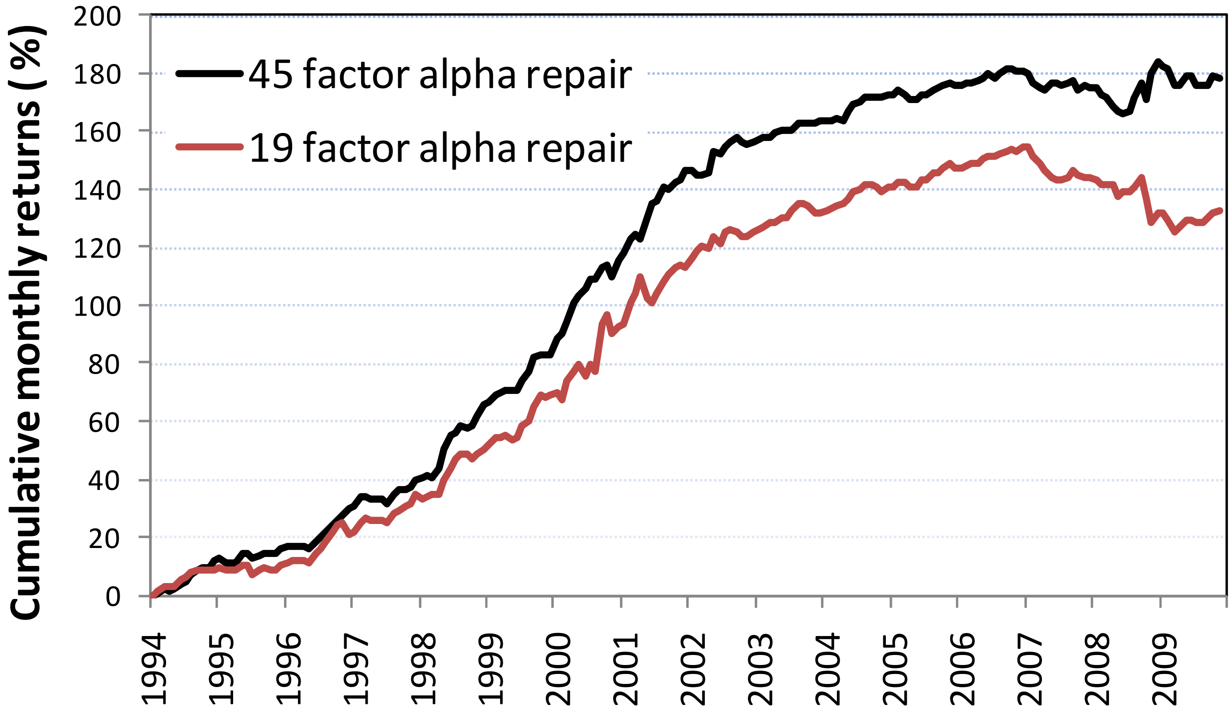
Why so many factors to choose from with *Alpha Repair*? … because you never know



Note: Black line shows monthly cumulative returns of Alpha Repair algorithm-selected 3-factor portfolios from 45 factors; red line shows monthly cumulative returns of Alpha Repair algorithm-selected 3-factor portfolio from 19 factors. Universe is Russell 1000. Period of analysis is from June 1994 through April 2010. Transaction costs are not considered.

Source: Nomura Securities International, Inc., Compustat, Russell, IDC.

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Alpha Repair – cumulative excess returns of US & Japan long-only

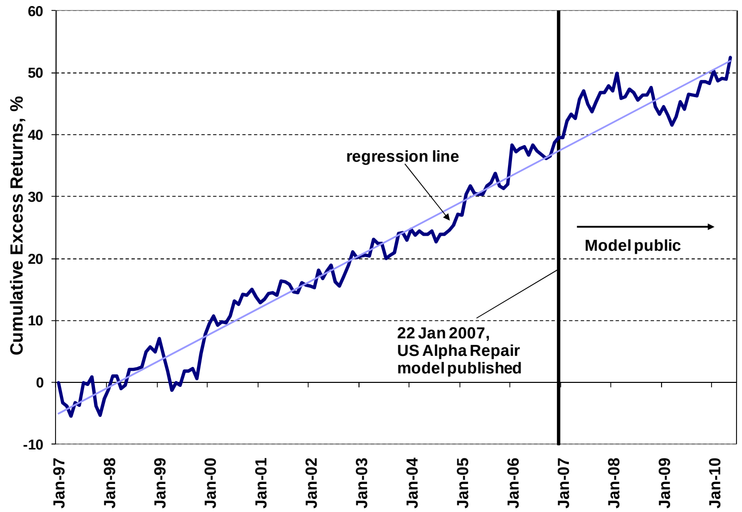
US

Outperformed Russell 1000 by:

4.1% in 2010 YTD

4.4% annually past 5 yrs

4.3% annually past 10 yrs



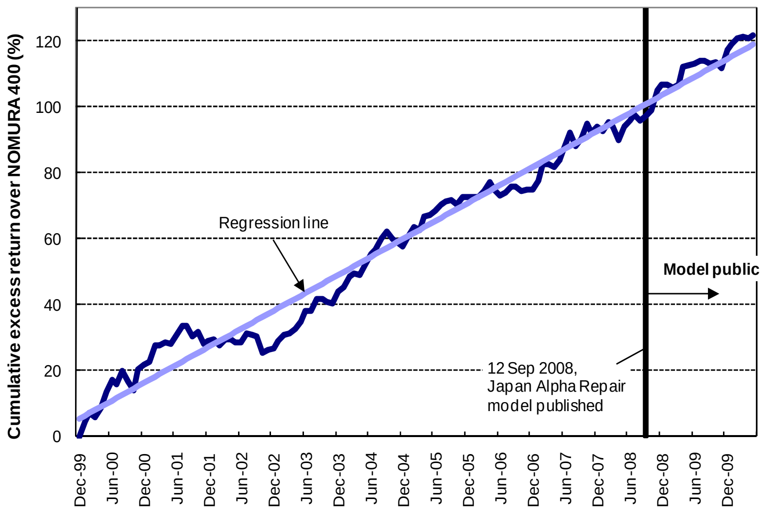
Japan

Outperformed NOMURA 400 by:

4.6% in 2010 YTD

10.9% annually past 5 yrs

10.8% annually past 10 yrs



Note: For top panel, universe is Russell 1000; for bottom panel, universe is NOMURA 400. Performances of model portfolios are calculated relative to the universe. The portfolios are rebalanced monthly , with annual turnover limited to 50% (US) and 180% (Japan) one-way. The target tracking error to benchmark is 6% per year. Transaction costs are not included. Past model performance should not and cannot be viewed as indicative of future performance; complete details available upon request.

Source: Nomura Securities International Inc., Compustat, I/B/E/S, Russell, and IDC.

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- **Systemic risk** – diversification challenge and the

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Any Authors named on this report are Research Analysts unless otherwise indicated

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