

What's New at Arrowstreet?

In April 2010, we established Arrowstreet Capital Europe Limited to provide a local presence for business development and client service in Europe. We are very excited about this announcement as this is our first office outside of Boston. In this issue of the Journal we highlight a recent Arrowstreet research piece, *Dead or Destabilized: Anomalies in an Age of Automated Arbitrage* written by Partner and Chief Investment Officer Peter Rathjens, Ph.D.

Q3 2010 Review:

Global equity markets rebounded during the third quarter, although much of the increase was concentrated in a strong September. Unemployment remains near highs across much of the world, but asset prices and gross domestic products have begun to recover.

Business Growth:

During the third quarter, Arrowstreet gained two new client relationships and firm-wide assets under management reached \$28.9 billion.

Team Members:

In this edition of the Journal, we profile Colin McLatchie and Laura Szomjassy, who joined Arrowstreet's Business Development team in 2010. Please turn to page 3 of the Journal to learn more about Colin and Laura.

As always, we are interested in your views and encourage your feedback. Please email your thoughts to us at:
info@arrowstreetcapital.com

Dead or Destabilized Anomalies in an Age of Automated Arbitrage

Peter Rathjens, Ph.D.
Partner, Chief Investment Officer

The business of active asset management is fraught with perils. Market inefficiencies are far and few between, they are difficult to distinguish from spurious patterns found by mining historical data, and they can easily fail to cover the risks and transactions costs they engender. Perhaps most frustrating of all, however, is the inconsistency caused by competition among active investors seeking to exploit the same inefficiencies. Such competition has always existed, but is particularly ferocious in the modern era of quantitative investing, which allows investment insights to be implemented across many stocks at low cost. Any realistic active investor soon comes to the painful realization that in the age of automated arbitrage, what worked in the past may not work the same way in the future.

This note explores two distinct ways in which competition among active investors, or arbitrageurs, can change the behavior of market inefficiencies, or anomalies. First, arbitrage activity can eliminate an anomaly so that it becomes "dead", with no further profits to be made from it. Second, arbitrage can alter the dynamics of the anomaly so that profits become more volatile, but no lower on average and possibly predictable over time. Such a "destabilized" anomaly can still be profitably exploited, but poses special challenges to active investors.

For a complete version of this article, please visit:
http://www.arrowstreetcapital.com/research_whitepaper.htm
For complete versions of other white papers, please contact us.

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September 2010 Investment Outlook Global/International Equity Strategy

Developed Markets Overview: 3rd Quarter 2010

Global equity markets rebounded during the third quarter, with the MSCI World Index rising 13.89% percent in USD terms. Much of the increase was concentrated in a strong September, when the index rose 9%. Although unemployment remains near highs across much of the world, asset prices and gross domestic products have begun to recover. In the United States, the Chicago Purchasing Managers' Index rose to 56.3 in August, from 55.5 in July, both indicating expansion.

Germany lagged the broader market, with the DAX trailing the World index by 9% over the quarter, as their export based economy suffered from a strengthening euro. They had been the primary beneficiary of a weakening currency, a trend more related to the European Union's overall weakness than to Germany's own macroeconomic performance.

The United States, whose S&P 500 index was up 10.7% for the quarter, amplified their rhetoric over the Yuan's valuation and introduced legislation aimed at increasing the Obama administrations power over tariffs, further embattling trade relations with China.

Hong Kong was the best performing developed country in local currency terms during the third quarter of 2010. The country index advanced 21.5% over the three-month period. Hong Kong's outperformance was paced by the Industrials sector, where Hutchison Whampoa constitutes 62% of the MSCI basket. The worst performing developed country was Ireland, whose MSCI country index declined by more than 13% in the third quarter, highlighted by a 13.3% drop in the month of August. Irish Materials were the laggard in the country index, dropping 30% in the third quarter.

All sectors in the MSCI World index posted positive returns in the 3rd quarter of 2010, with five sectors posting double-digit gains. Telecommunications Services stocks were the best performer as the sector posted a 13% gain for the quarter. Swedish telecommunications company, Tele2 AB, rose 39% on the quarter after being upgraded at HSBC to "overweight" and announcing its Russian operations added 436,000 new customers, more than half of which come from new regions. Also boosting sector performance were shares of Spanish telecommunications giant, Telefonica SA, which gained 19%. Health Care stocks were the least positive contributor to index performance in the third quarter. The Health Care sector rose 6% in the last three months. Detracting from sector performance was laboratory systemsmaker, Beckman Coulter Inc, whose shares sank 19% on the quarter after reporting a 27% drop in Q2 profit.

Developed Markets Strategy Performance Attribution

Two country/sector baskets that impacted the performance of Arrowstreet's developed markets portfolios during the quarter are described here:

Spanish Consumer Discretionary: Spanish apparel company, Inditex, saw its share price rise 24% over the third quarter. The stock rallied on news that the worlds largest clothing retailer announced plans to begin selling merchandise online in six European countries. Inditex, the parent company of retailer Zara, also announced plans to continue its expansion in Bulgaria. Our overweight positioning in the stock was based upon favorable basket level momentum and basket level value signals.

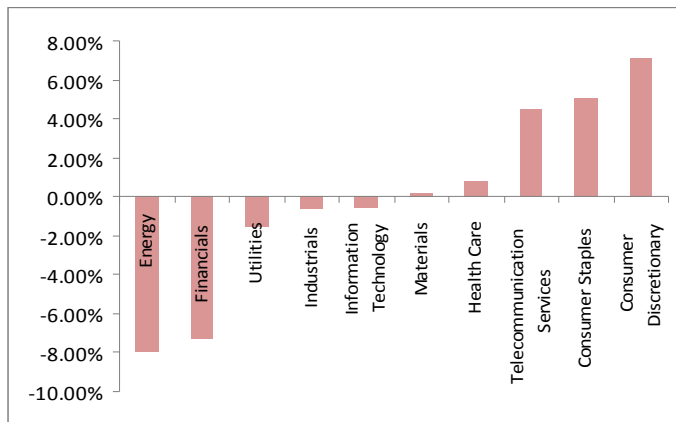
Dutch Industrials: The Dutch electronics corporation, Philips, experienced a drop in share price at the beginning of July following a court ruling accusing a group of technology companies (including Sony, Hitachi, and Philips) of fixing prices of optical disc drives. Philips' price plunged again on concerns that sales growth would slow in the second half of the year. Our overweight position was motivated by basket level momentum and country level macroeconomic signals.

Specific opportunities that we believe will offer attractive return potential include:

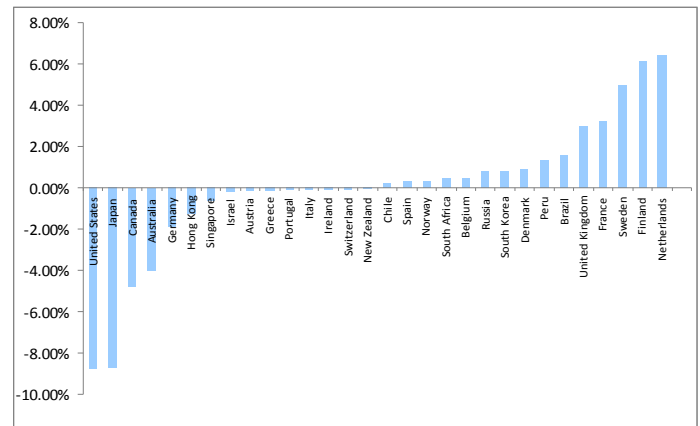
Credit Agricole S.A. (France Financials): Credit Agricole S.A. is the lead bank of the Credit Agricole Group. Shares of the company gained 33% in the third quarter on speculation that future changes in French banking policy could result in higher earnings. Banking shares climbed in late July after the Basel Committee on Banking Supervision agreed to allow certain bank assets to count as capital. In September, regulators announced that they would give banks more time than analysts had expected to comply with more stringent capital requirements aimed at preventing another financial meltdown. Our positive outlook in Credit Agricole shares is based on positive basket level and stock level value signals.

Umicore S.A. (Belgian Materials): Shares of Belgian materials company, Umicore, rose 33% during the third quarter. Shares surged as analysts at BNP Paribas and JP Morgan upgraded the stock. Shares of the world's largest precious metals maker also rose as the company announced higher guidance for operating earnings. Our overweight positioning in the stock was due to favorable basket level momentum and value terms.

**September 2010 Active Sector Weights (%)
(MSCI World)**



**September 2010 Active Country Weights (%)
(MSCI World)**



Data provided above is for Arrowstreet's longest standing representative portfolio for the Global Equity strategy as of the end of September 30, 2010.

September 2010 Investment Outlook Emerging Markets Equity Strategy

Emerging Markets Overview: 3rd Quarter 2010

Emerging markets advanced through the third quarter, outperforming developed markets. The China Purchasing Managers' Index rose to 53.8 in September, after a reading of 51.7 in August, both beating analyst expectations. Readings above 50 in China's PMI indicate expansion. Brazil's benchmark Bovespa Index advanced to its largest quarterly gain in a year. Industrial production expanded for the thirteenth consecutive month in South Korea, while exports grew for the tenth consecutive month.

Emerging market countries benefitted from improving economic conditions across the globe. The South African rand, the Polish zloty, and Brazilian real appreciated significantly against the United States dollar during the third quarter. Raw materials and metals producers, such as Vale SA and Southern Copper, benefitted from rising commodity prices.

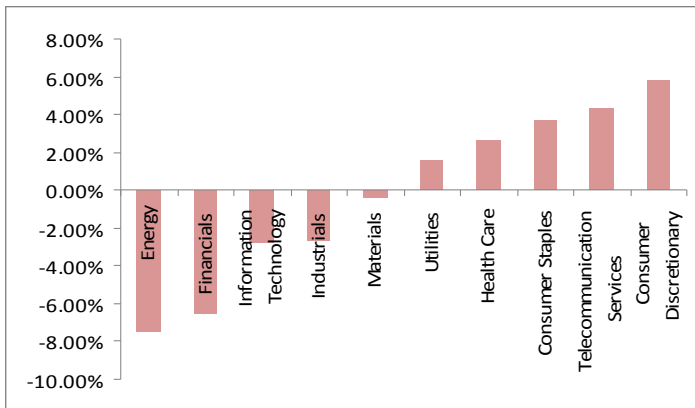
Among emerging market countries, Argentina was the best performing developing country in USD currency terms during the third quarter of 2010. The country index advanced 41.5% over the three-month period. Argentina's outperformance was paced by the Financials sector, where all three constituents realized greater than 50% gains in their stock price. The worst performing developing country was Morocco, whose MSCI country index lagged others after advancing 8% in the third quarter in USD terms. The underperformance was driven by the Financials sector, where the index gained 5% during the quarter.

All ten sectors in the MSCI Emerging Markets index performed positively in the 3rd quarter of 2010, bouncing back from a very poor Q2. Industrials stocks posted the biggest gain as the sector rose more than 25% during the quarter. Also gaining 25% during the last three months was the Consumer Discretionary sector. Chinese automaker, Dongfeng Motor Group, soared 73% in the third quarter on positive headlines. China auto exports doubled in the month of July and Dongfeng was one of five main beneficiaries. Utilities stocks were the least positive contributor in the third quarter as the sector rose 10%. Indian utility company, Reliance Natural Resources Ltd, sank 41% in the third quarter after the company announced its intention to merge with Reliance Power Ltd in a stock deal that would dilute Reliance Natural Resources shares.

Emerging Markets Strategy Performance Attribution

Two country/sector baskets that impacted the performance of Arrowstreet's emerging markets portfolios during the quarter are described here:

**September 2010 Active Sector Weights (%)
(MSCI EM Index)**



Chinese Consumer Discretionary: Shares of Hong Kong-based automobile company, Dongfeng Motor Group, rose 73% over the third quarter, driven by an increase in August exports of Chinese cars by 115% from a year earlier. The company announced that it would introduce hybrid and electric vehicles within two years, projecting that the new product line would account for 20 percent of the company's production in four to five years. Dongfeng will invest 3 billion Yuan over the course of five years to fund the development. Our overweight position in the stock was motivated by stock level value and stock level earnings signals.

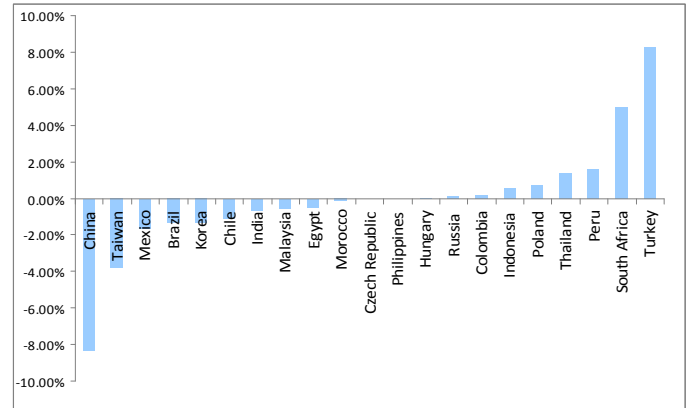
Brazilian Utilities: Shares of Eletrobras declined for the second straight quarter, declining 10% in the previous three months. Latin America's largest utility announced plans to raise as much as \$4 billion via bond sales and loans to capitalize on declining borrowing costs. Brazil's state controlled utility announced plans in late July that it would potentially acquire a United States utility company, and that due diligence had already begun. Our overweight position in the stock was motivated by favorable basket level momentum and value terms.

Specific opportunities that we believe will offer attractive return potential include:

MTN Group Limited (South Africa Telecommunications): MTN Group, Africa's largest mobile phone operator, plans to continue its growth in the twenty-one countries in which it conducts business. The company experienced a 60% increase in revenue from data services over the first six months of 2010. The expansion of 3G technology has allowed the company to provide more data capabilities for its customers. MTN announced plans to build as many as one thousand new base stations to increase its scope in South Africa, providing more data infrastructure as well as additional voice and text communication. We view the shares as attractive based on favorable basket level earnings and country level macro-economic terms.

LG Corp (Korea Industrials): South Korean conglomerate LG Corp continues to expand its business mix by bolstering current divisions as well as new acquisitions. LG Corp announced plans to enter into a joint venture with Korea Resources to acquire a 20% stake in a United States copper mine. LG also bought a 50% stake in United Copper & Moly. The company announced plans to create a 250 billion KRW fund offering low interest loans to financially assist local contractors and suppliers. We view LG Corp as an attractive investment based on positive basket level momentum and stock level value signals.

**September 2010 Active Country Weights (%)
(MSCI EM Index)**



Data provided above is for Arrowstreet's longest standing representative portfolio for the Emerging Markets Equity strategy as of the end of September 30, 2010.

Employee Profiles



Laura Szomjassy
Associate, Business Development
Laura is responsible for supporting Arrowstreet's sales and marketing efforts. Prior to joining Arrowstreet, Laura was an Institutional Marketing Specialist at Pioneer Investments. Laura graduated from the University of Richmond with a B.A. in Political Science in 2007.

Colin McLatchie
Director, Arrowstreet Capital Europe Limited
Colin is responsible for servicing our European clients, and is based in Edinburgh to be in close proximity. He has a long career in the region, including having served on the Board of the UK's Investment Management Association. Most recently, he was chief executive of AEGON Asset Management UK. Skier, cross-country runner, and motorsport enthusiast, he moves fast to keep up with his young family as well as the pace at Arrowstreet.

