

Montecito Private Asset Management, LLC

MPAM

Asset Allocation Seminar

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WHAT'S WRONG WITH ASSET ALLOCATION TODAY?

In a recent research piece entitled, [“Where is the Investment Management industry headed, and why should you care?”](#) (available at www.mpam.bz), I wrote extensively about the state of the investment management industry, and more specifically about some of the pitfalls of the current asset allocation process. In this seminar, I will expand upon those pitfalls, add some numerical support for my arguments, and offer an alternative to the current asset allocation approach.

So what is asset allocation, and why should we care? Asset allocation is simply the combination of investment vehicles within a portfolio and their percentage weightings within that portfolio. Asset allocation accounts for up to 90 percent of total portfolio performance, so the asset allocation decision is the most important decision, by far, that we will make when structuring portfolios; far more important than the individual security selection decisions we will make.

I would like to highlight some of the problems I see with the current asset allocation process so a comparison can be made between the current process and my alternative. Next, I would like to examine some performance data for various indices, spanning a broad range of investment approaches, to support my position that the current asset allocation approach is faulty, and to further support my alternative approach to asset allocation. Finally, I will conclude this seminar with a summary of my thinking on the current state of the economy, financial markets, and investment opportunities.

Historical averages

So let's take a quick look at the current method of producing an asset allocation, so we may understand the specifics of the process and the problems with it. The current asset allocation approach is based on software packages that use long-term historical averages for returns and risk factors for each asset class. Normally, these software programs use twenty-five years of data, if available, and then take a simple average for the returns and risk factors, again for each asset class.

So, for example, a software package will take quarterly performance returns and their associated risk factors (usually standard deviations) for large-cap growth stocks, possibly using the Barra large-cap growth stock index or another similar index. Then, a simple average over the twenty-five year time-frame will be taken for the returns and for the risk factors (with four quarters per year and twenty-five years, the software would add-up all of the returns over the twenty-five year period (all one hundred), and then divide by one hundred to get the simple average. The same would be done for the risk factors.) The same would be done for each asset class. Each quarter, the software is typically updated with the most recent quarter's data, and the first quarter, going back twenty-five years, would be dropped (replaced by the

most recent quarter's data), so that you would always have one hundred data points. This is called a simple moving average.

Here's the problem with this approach: The use of a simple moving average waters-down the many fluctuations each asset class will experience in terms of performance, over time. Additionally, standard deviation (risk) can change over time, as the volatility of returns increases or decreases. Taking an average of the standard deviation is especially detrimental to the process as (standard deviation is already an average of the deviations from the average of returns over time. Without getting too deeply involved in the math of these calculations, I want to simply make the point that when you start taking averages, you lose a lot of the integrity of the data series, so that the usefulness of the data is significantly diminished.

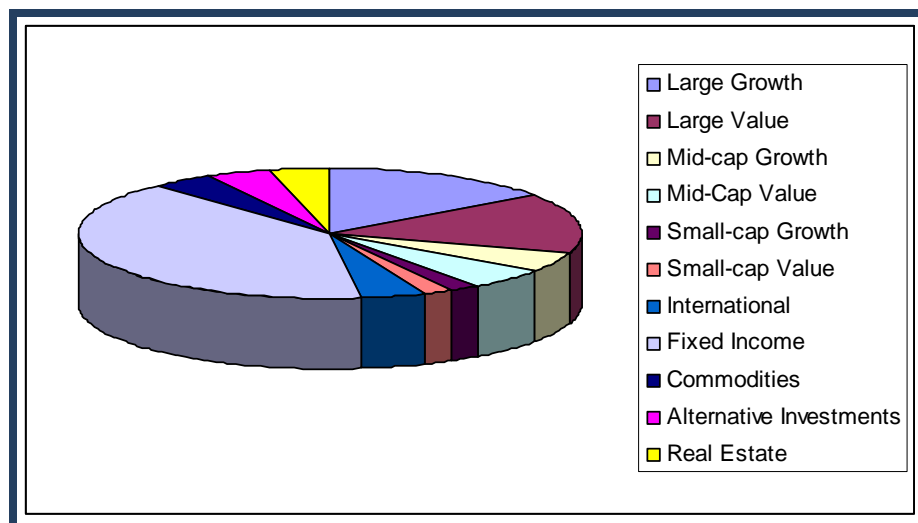
The most important shortcoming of this historical data approach is that **there is no guarantee that what happened in the past will happen in the future.** The first thing one will see on any marketing materials for any investment is a statement that reads something like this: Past performance is no guarantee of future results. Exactly!

What is most important in terms of making asset allocation decisions is *not* what happened in the past, but incorporating what is *most likely to happen* in the future. Would we buy a house as an investment in Santa Barbara today, based on what house prices have done over the past fifteen years, or based on what we think will happen in the next fifteen?

By doing our homework on the current economic and financial market environment, we stand the best chance of making judgments on what is most likely to happen in the future. Based on our assessment of the current environment and how that environment is likely to impact the various asset classes, we can make our asset allocation decisions based not on historical information, but on the information that will have a direct influence on the investment vehicles we choose. (More on this below.)

Traditional Asset Allocation versus the Core / Satellite Asset Allocation approach

The current asset allocation approach, using the software packages I discussed above, will typically produce a pie chart, with the individual slices of the pie representing the recommended percentage weightings in each asset class, with the whole pie representing the investor's entire portfolio. It will normally look similar to this:



The traditional asset allocation approach, or what I refer to as the old way, has some serious shortcomings, in addition to those already explained above.

No coordination

First, there is no coordination among the various asset classes. For example, if the investor hires a different investment manager (or chooses a different mutual fund or ETF) for each asset class, there will be no communication among the various investment managers. One will have no idea what the others are doing, and frankly won't care.

Manager specialization

This leads me to one of the most significant problems within the investment management industry today, so please allow me to step onto my soap box. About twenty years ago, right around the time I entered the investment management business, asset allocation (the traditional approach) was just gaining popularity, and the software packages that I discussed above were just being developed. Once the software was adopted by the investment management industry, it didn't take long for investment managers to realize that, if they wanted to increase their assets under management, (to make more money), they had better conform to what the software was recommending, otherwise they would be out of a job because they would not only not get new assets to manage, but they would lose what they had to those managers who did conform.

For example, if a manager used an investment strategy that was not clearly defined as an asset class that was recommended by the software, all brokerage firms and other advisors would not include them in their recommendations to their clients, and so, the manager would not get new business. So, as a manager, if you wanted to stay in business and wanted to succeed, you found out very quickly that you had better fit

within the structure of the software; or else. This led very quickly to managers choosing very defined styles, which conformed perfectly to the individual asset classes within the software packages.

If a manager had previously moved from large-cap to mid-cap to small-cap, and from value to growth, depending on market conditions, he or she would have to pick one asset class to focus upon, in order to stay in business. This led to specialization, wherein managers selected the asset class they felt they had the most expertise within, and to their focus upon only that asset class. Advancements within the industry in terms of monitoring the asset allocation process and the performance of the individual managers further delineated the divisions between managers, so that today, if a manager deviates ever so slightly outside his specified asset class, he faces a high probability that he will be fired for what is called style drift.

The upside of this specialization is the **increased level of expertise** for the manager within their area of specialization. The downside is **reduced flexibility** to adopt their strategies to the ever-changing investment environment. For example, a value manager is stuck with value investing, whether the current and future investment environment favors value investing, or does not (favors growth instead). A value approach in a growth environment will likely result in substantial underperformance, but a value manager cannot deviate from his stated investment approach. If he or she does deviate, the entire asset allocation process falls apart. Again, even if the manager believes that value investing is out of favor, and will remain out of favor for a long time, he or she must continue to invest in value. It should be clear to anyone reading this, that this level of inflexibility is less than ideal, to say the least.

Duplication

Another problem with the current asset allocation approach stemming from the lack of coordination among the various managers is duplication of positions. Each manager knows nothing of what the other is doing, and even with very distinct and varied investment approaches, there is always the possibility of duplication of positions. If positions are duplicated, the risk to the investor is increased to unacceptable levels and diversification is reduced. Again, the entire asset allocation breaks-down if there is widespread duplication.

Costs

Costs are another major drawback to the old asset allocation approach. The more individual investment vehicles contained within the portfolio, typically the more expensive the portfolio will be to **establish and manage** over time. Also, any opportunity for **breakpoints** on fees may be lost as the amount managed by each manager will be less, the more managers there are. Finally on costs, the more managers included in the portfolio, the more difficult it will be to **monitor** the performance and risk parameters of each manager and of the portfolio as a whole, and

the less likely it will be that the investor could manage the asset allocation process themselves, potentially resulting in the additional cost of a consultant.

Coordinated tax strategy

With the old approach, it is virtually impossible to have a coordinated tax strategy, so tax efficiency is drastically reduced or completely eliminated. Each manager is not aware of what the others are doing (no coordination), so there can be no coordination for harvesting tax losses, matching gains and losses, offsetting other gains the investor may have taken on outside assets such as real estate or a stake in a private company, etc. Each manager, in keeping with their specialization, is trying to maximize the returns of their investment approaches, on a *pretax* basis. They have no idea of the individual tax needs of the multitude of individual investors, corporations, institutions, foundations, etc, whose assets they manage. For non-taxable investors, obviously this is not a concern. But for those who pay taxes, the lack of tax coordination is a big negative.

No customization

Also, there is no customization within each asset class. For example, a large-cap growth manager manages money exactly one way—each portfolio the manager runs holds the same positions in the same weightings, regardless of the owner of the portfolio. Again, they have no motivation to customize portfolios, and in fact, will be punished severely if they deviate from their stated investment objective (they will be fired in all likelihood).

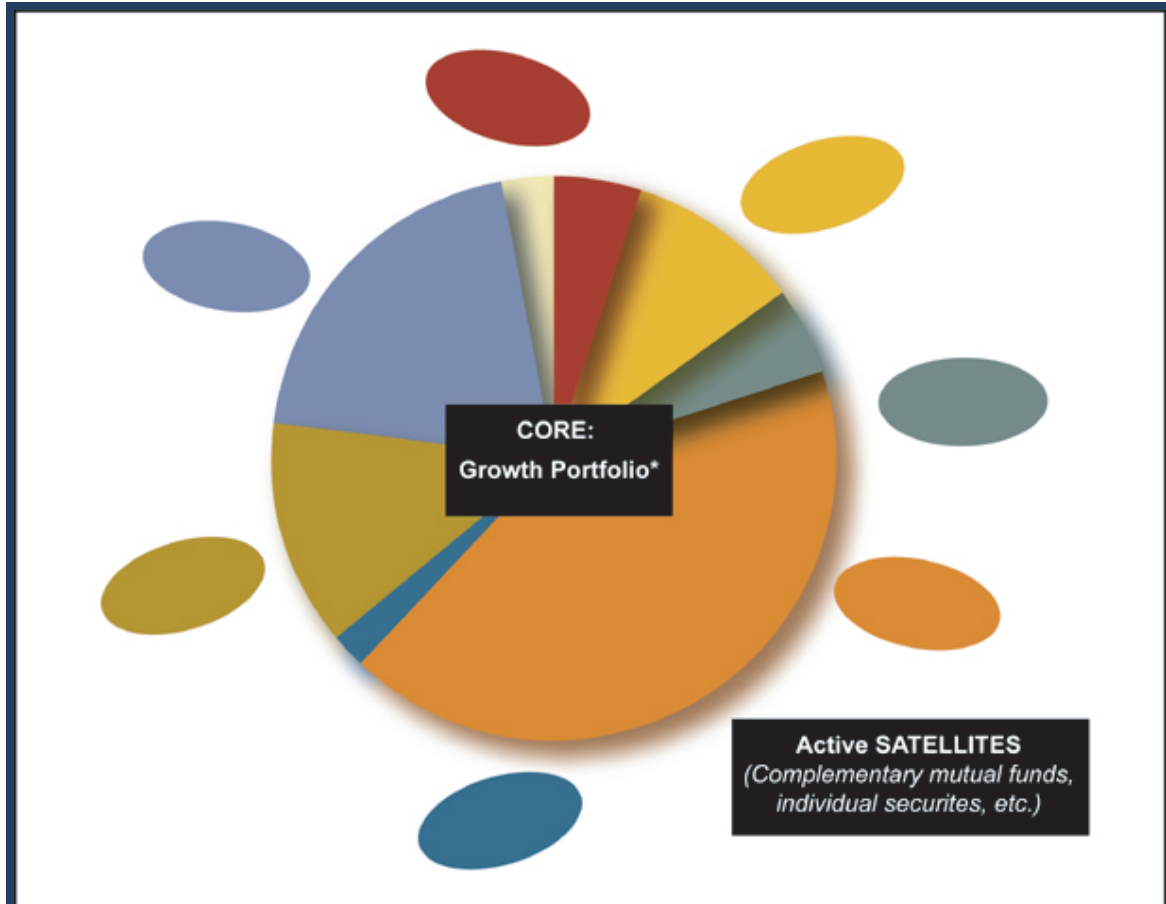
No direct communication

Finally, there is no direct communication between the investor and the people managing their money. I cannot understand how anyone can believe that the best way for a person to have their money managed is to separate the investor completely from the people making the decisions about how the money is invested, but that's exactly what happens using the old approach. Without direct communication, you cannot have responsibility and accountability. And, in most cases, the investor will have a difficult time understanding what is being done with their money, and why. This is not ideal for the investor, to say the least.

THE CORE / SATELLITE APPROACH

There is a new way of structuring an asset allocation that is gaining popularity today, which is called the Core / Satellite approach. In simple terms, it involves choosing a core investment vehicle, which could be an index mutual fund or ETF, an actively managed mutual fund or ETF, or an investment manager, either with a separate account approach (as I use), or a hedge fund approach. This core investment vehicle, which typically accounts for about 75% of the total portfolio weighting, would then

be surrounded by satellite investments, chosen specifically for their individual characteristics and how these characteristics enhance the risk-adjusted performance potential of the overall portfolio. This asset allocation approach would look something like this:



POTENTIAL DRAWBACKS TO THE CORE / SATELLITE APPROACH

Still no investment coordination, no tax coordination, the potential for duplication still exists

There are some potential problems with the core / satellite approach as well. First, if an index fund, mutual fund, ETF, or an investment manager with a specific specialty, as outlined above, is used for the core strategy, just as with the old way, there will be no internal coordination of the investment process (the investor will be responsible for the coordination, unless they hire a consultant or financial advisor to do it for them). There will be no tax efficiency, and duplication of positions is still a possibility.

Monitoring, communication, and costs

The investor will still either need to monitor the performance and risk of each investment vehicle him or herself, or hire a consultant to perform this task. And, as with the old approach, there is no direct communication between the investor and the managers, which does not foster accountability, responsibility, transparency, or communication.

However, costs may be considerably lower, as there will be fewer investment vehicles overall, and if an index fund is used for the core strategy, which again typically will account for about 75% of the total asset allocation, the ongoing cost of the portfolio can be a fraction of the costs associated with a portfolio structured using the old asset allocation process. Also, if the investor monitors the portfolio him or herself, costs should be considerably lower, as the process will be much less complicated.

Historical Asset Class Performance

Just to highlight a point I made above concerning out of favor asset classes, let's take a look at some annual returns of various asset classes (see table below). What you will find is that during different periods of time, some asset classes will outperform, while others underperform. I highlighted the top performing asset class in green and the worst performer in yellow, for each year. I also separated the top three (S&P 500, S&P 400 Mid-cap, and Russell 2000) from the rest. These top three represent large, mid, and small-cap, with no designation between growth and value.

INDEX	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
S&P 500	22.96%	33.36%	28.58%	21.04%	-9.11%	-11.89%	-22.10%	28.68%	10.88%	4.91%	15.80%	5.49%
S&P 400 MID-CAP	19.20%	32.25%	19.11%	14.72%	17.51%	-0.60%	-14.51%	35.62%	16.48%	12.56%	10.32%	7.98%
RUSSELL 2000	16.49%	22.36%	-2.55%	21.26%	-3.02%	2.49%	-20.48%	47.25%	18.33%	4.55%	18.37%	-1.57%

MSCI U.S. Large-cap Growth	23.61%	36.83%	49.73%	39.79%	-29.12%	-22.49%	-28.04%	27.33%	6.15%	3.30%	9.10%	11.73%
MSCI U.S. Large-cap Value	22.78%	32.41%	17.59%	6.95%	6.91%	-5.28%	-18.15%	28.38%	13.25%	6.11%	23.36%	1.17%
MSCI U.S. Mid-cap Growth	18.93%	20.60%	17.26%	70.53%	-26.29%	-20.43%	-23.33%	40.26%	13.82%	15.02%	9.67%	17.40%
MSCI U.S. Mid-cap Value	21.46%	37.08%	1.52%	2.20%	22.47%	8.79%	-9.69%	37.91%	27.17%	12.85%	17.82%	-4.41%
MSCI U.S. Small-cap Growth		14.56%	6.63%	49.55%	-8.25%	-6.29%	-29.31%	50.37%	16.13%	8.71%	12.03%	9.71%
MSCI U.S. Small-cap Value	23.52%	34.73%	-5.12%	-2.17%	21.22%	12.95%	-6.63%	44.34%	23.72%	6.28%	19.44%	-6.94%
MSCI EAFE Index (Intl. Index)				25.27%	-15.20%	-22.61%	-17.52%	34.49%	18.27%	11.92%	22.26%	8.67%

* Returns are price change only (no dividends or distributions included), except for the SPX, MDX, and RUT.

An asset class that outperforms one year may very well be the one that underperforms during the next. Just to punctuate this point, look at the returns for the MSCI U.S.

small-cap growth index for 2002 and 2003. In 2002, this index had the worst performance, relative to all others, with a loss of 29.31%. The very next year, the same index returned 50.37%, and was the best performer of all. Ideally, an investor would have wanted to avoid this asset class in 2002, but to be overweight it in 2003.

(Keep in mind that these are calendar year returns. Normally, the period of time that an asset class outperforms or underperforms will not exactly coincide with the calendar year, so to some extent, these returns are not as pronounced as they would otherwise be, if for example I used the exact time-periods during which the asset class under or outperformed. But, these data serve to prove my point well-enough.)

I have also added a piece from Fidelity at the end of this paper, which shows a similar grid, but ranks all asset classes from best performer at the top of the page, to worst at the bottom, for each year. If you take a look at that grid, you will see the same characteristics I have identified in the table above, which is that asset classes that are in favor one year, may be the worst performers the next, and vice versa.

Conclusions

Now, some would say that it is not possible to anticipate which asset classes will do well and which will do poorly, from one time-period to the next. If this were the case, there would be no reason to ever pay a manager to invest, and investors would do the only rational thing, which would be to buy an index fund and forget about it. Clearly there are many managers out there that consistently make money, and beat their respective benchmarks, so I reject this entire line of thinking. And, if markets were efficient, we would never have big spikes on the upside, nor huge drops like we had last year.

As I have repeatedly written, this whole line of thinking regarding the efficient market theory and passive investing is based on faulty statistical data from a study some academicians performed, where they said if an investor missed the best performing ten days in the stock market (S&P 500), over the previous ten years, their returns would have dropped from about 12% annualized, to about 4% annualized. Their conclusion: market timing doesn't work, so therefore everyone should just invest passively (with an index fund).

There are so many problems with this study that I don't want to waste two pages writing about it (again). You can visit my website for more details on the study, but the key thing I would point-out is that the study assumes that the best ten days would be missed, but they also assume that the worst ten days would not be missed. In other words, they assume the investor would miss the best ten days but stay invested during the worst ten. They also used the returns of the S&P 500, which obviously does not relate directly to what an active manager would invest in. Clearly the conclusions of this study depend on assumptions that fall apart is the stark light of reality.

So what's the answer?

What I have tried to do is to take the best of both asset allocation approaches—traditional and core / satellite—and combine them into an asset allocation strategy that works, providing coordination, flexibility, low cost, tax efficiency for taxable investors, transparency, communication, and most importantly direct accountability to the investor. I also apply the overall asset allocation strategy to a sector rotational strategy, which is just a fancy way of saying that I overweight those sectors of the economy that I believe, based on my expectations for the economy and financial markets, will perform well, and under, zero, or negative weight (short) those sectors which I believe will not perform well.

By using a core / satellite approach, with an active manager as the core manager, who performs the functions necessary to provide coordination, flexibility, communication, etc, and adding satellite asset classes that enhance the risk-adjusted returns of the overall portfolio, particularly in asset classes that compliment the expertise of the core manager, I believe the investor will have the best opportunity to accomplish their true, long-term financial goals.

So how do we know how to pick the asset classes for our portfolios?

Those of you reading this that are also members of my email commentary list will already have a good sense of my expectations for the markets and the economy, but I would like to summarize my current thinking, as it related directly to making an appropriate asset allocation decision. As stated above, the asset allocation decision should be based, not on historical average returns and risk factors, but on current economic and financial market data, and expectations of future performance of the economies and financial markets of the world, based on this current data.

The Dollar

On the economic front, I expect the dollar to continue to strengthen slightly over the next few quarters, relative to the euro, pound, and Asian currencies. I expect the U.S. economy to begin to recover by the second half of 2009, with the U.S. housing market starting to show the first signs of bottoming sometime in late 2009 or early 2010. I would expect foreign economies of developed countries to follow the U.S. recovery fairly quickly, with emerging markets to lag.

Stocks

Given this overall economic view, I would overweight U.S. investments for the next few quarters, looking to invest in developed economies starting early in 2010, and emerging markets sometime around late 2010. Within the U.S, mid-cap and large-cap growth will be my focus. Although I expect small-cap to continue to do pretty well, mid and large-caps look more attractive, and valuations on the largest, strongest, best

capitalized companies with the best product lines and dominant market share are at levels we haven't seen in decades in some cases. Their valuations are similar to what you would normally find in much riskier, smaller companies, so I see no reason to buy small companies when you can buy the biggest and best for great prices.

Within U.S. mid-cap and large-cap names, I continue to prefer the Financials, Technology, Industrials, and Consumer Discretionary sectors. I recently added some small positions in the energy sector, as these stocks have been hammered since the bubble in energy burst in the second half of 2008. Oil appears to have set a bottom, and although I expect a high level of volatility, I think we have seen the lows for energy.

Commodities

On the commodities front, I remain short gold, and believe all commodities will fall further in price for the near-term. Oil has bounced from the low \$30s to the low \$40s, and may retest the low \$30s before stabilizing. Falling demand worldwide should provide continuing pressure on most commodities prices. If you couple falling demand with the extreme high prices we witnessed last year, it is easy to see how commodities prices can continue to drop from here. We are in a deflationary environment, and although I think we will have to worry about inflation in the years to come, right now price inflation is not a concern, so commodities really do not look attractive. As the world economy begins to recover, demand for commodities will increase, but price levels on many commodities remain somewhat elevated, so the potential for sizable upside is somewhat muted from current price-levels.

Real Estate

I do not expect home prices to start to form a bottom until late in 2009 at the earliest, and even then, I do not expect any material upside in prices to develop for several years. Home prices will likely overshoot to the downside, and there could be a bounce from that overshoot, but then a flat market will likely follow for as many as five years. Without the upward pressure from speculators who accounted for the vast majority of upside during the boom, I do not expect to see home prices rising by much more than the rate of inflation, even after the bottom forms and a few years pass. The long-term average rate of increase for real estate nationwide over the past fifty years has been about 5%, and this includes the boom times we have witnessed along the way. I expect to see something in this neighborhood for price appreciation overall, once we get past the bottoming process.

The take-away should be that real estate, as an asset class, will not be attractive, in a general sense, for many years. With that said, as in any market, for professionals who understand the market and have expertise in identifying and purchasing distressed properties, or for contractors who buy properties and remodel them, there will always be opportunities. But, for the average person, real estate just won't offer much in the

way of returns, at least not compared with stocks. I will likely start to look at real estate sometime in late 2010. Look for the current bottoming process to take about as long as the last one from the peak in 1989. We did not see the bottom hit until prices had declined from 1991 through 1993, and then we did not experience any meaningful upside until 1996, a full five years after the decline had started. I expect this bottoming cycle to last at least as long as the last.

On a local basis, my hope is that we will bottom sooner, and also rebound sooner, as the dynamics of the local real estate market and the local economy are significantly more favorable than the nation as a whole, and as most of the markets that witnessed the largest percentage increases in real estate prices during the boom. With that said, I do not believe we have seen the worst that this real estate contraction, or that the recession will inflict upon the local economy. I expect another 15% to 20% of downside in local real estate prices before we see the bottom. But again, my hope is that we bottom early and rebound early, and that the overall weakness for local real estate and the local economy is less severe than that of California of the country as a whole.

Bonds

On the bond market, prices are very expensive, and yields are very low historically speaking. Bonds rallied in price from the end of the third quarter when Lehman failed and the flight to safety stampede occurred. Treasury bills actually briefly went to a negative yield, meaning that purchasers of T-bills were paying the government to hold their money. The current prices of bonds make them unattractive compared with stocks.

Treasuries are at sixty year-plus lows, and prices across the yield curve are in a massive bubble. This year, prices have started to come down, with the yield on the 10-year treasury rising from 2% at the beginning of 2009 to about 3% today. This represents a massive amount of cash flowing out of treasuries. I remain short treasuries, as I believe cash will continue to flow out of treasuries and eventually back into stocks, as the fear bubble deflates, and investors exit the safe-haven trade (from gold, CDs, money markets, and treasuries), and seek-out riskier assets; especially stocks.

We currently have about \$5 trillion sitting in money markets alone, and trillions more in CDs, and even more in treasuries. This is wholly different than what was experienced in the Great Depression, when people just didn't have any money; period. This is one of the many reasons I believe the economy will rebound in the short-run, and why we will not have another Great Depression... as this cash starts to flow back into stocks, investors and consumers will gain confidence in the markets and the economy, and the perception will become a reality. The stock market and consumer spending are the two most accurate predictors of recoveries, so we need to see improvement in both. I believe we will start to see signs of this improvement very

shortly for stocks, and by the third quarter for consumer spending, as the positive impact of the government's many stimulus actions take root.

If bonds, commodities, and real estate do not offer attractive opportunities, stocks are the only asset class left. This is my focus.

I hope this paper has been informative, and will provide the reader with a starting point with which to develop a useful asset allocation. Investors should understand the asset allocation process so that, should they hire a consultant or financial advisor to assist them in developing an asset allocation, they can ask the right questions and avoid some of the pitfalls I have outlined above. I wish you great success in your quest to achieve your financial goals.

Craig D. Allen, CFA, CFP, CIMA

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