

How We Create Portfolios

Our Asset Allocation and Fund Selection Discipline

The term asset allocation means different things to different people. Some investors equate asset allocation with short-term market timing. Others view it as a dynamic process of identifying longer-term valuation discrepancies between asset classes and taking advantage of these to either increase return without increasing risk, or to lower risk without sacrificing return. Some asset allocators use technical analysis (statistical models of price and volume data) to time shifts from one asset class to another. Others combine numerical analysis and qualitative judgment. Finally, some take a very long-term view of asset allocation and advise static allocations to various asset classes based on investor risk tolerance. There is no single "correct" way to allocate assets, though we don't advocate short-term market timing or sole reliance on technical analysis. [Click here](#) for more of our thinking on asset allocation methodologies.

Our asset allocation decisions assume a minimum three-year time frame. Three years is long enough to give us confidence that underlying investment fundamentals, rather than short-term market sentiment, will drive returns. However, we continually test the overall portfolio risk over one year. Occasionally this forces changes in portfolio allocations based on a long-term decision horizon—most of the time it doesn't.

There are three primary steps to our asset allocation for our four model portfolio types:

1. First we establish a neutral allocation for each portfolio type.
2. We shift our asset allocation away from neutral only when there are "fat-pitch" opportunities:
 - When one asset class is extremely undervalued relative to competing asset classes.
 - When cyclical or other factors don't significantly detract from the valuation story.
 - When long-term trends that we believe will have a major impact in defining the upcoming investment climate don't detract from the valuation story.
3. Finally we use scenario analysis to test the portfolios' exposure to various downside risks.

The following discussion, mostly in question and answer format, describes each of these steps.

Step One: Neutral Allocations

What is a neutral allocation? It reflects a logical, static, strategic asset allocation for a hypothetical long-term investor who is not using active asset allocation. It is based on our evaluation of the historical long-term risk and return relationships of the asset classes, and what we consider to be realistic and reasonable expectations going forward. It is the starting point for our active asset allocation process.

What is the purpose of the neutral allocation?

1. The neutral allocation is the asset allocation that we will implement when our conviction level about any specific asset class is not high enough to justify changing the asset allocation mix. It gives us a sensible long-term allocation, based on sound research.
2. It gives us a constant frame-of-reference against which to measure decisions. For example, if we like REITs, we must decide what they will replace in the portfolio and how far from neutral we will stray. This will be a function of our confidence and the impact on the portfolio's risk and return potential. The permanent frame-of-reference imposed by the neutral allocation increases the odds that we will consistently apply our methodology.
3. The neutral allocation also gives us a benchmark against which to measure our value added.

How did we choose the neutral allocations for each portfolio type? First we identified risk tolerances, defined as maximum losses over 12 months. Then we looked at many different combinations of asset classes over many historical periods. Through numerous iterations of adjusting the asset class mix, and looking at the results over various historical periods (over 55 years) that reflected differing circumstances, we came up with neutral allocations that:

1. Have very high statistical probabilities of not violating the stated risk tolerance for each model. (Though the probabilities are in the high 90% range, they are not 100%—there is no guarantee that the risk tolerance will not be violated going forward.)
2. Are diversified enough to provide some smoothing of performance.
3. Have delivered, over the average 10-year period, a higher return than a simple S&P 500/bond mix with slightly less variability. (In the case of equity portfolios, a higher return with less variation than the S&P 500.)
4. Make common sense as we look forward.

How did we choose which asset classes to include in the neutral allocation? We considered a variety of asset classes.

However, we decided to stick to mature asset classes for which we have good historical data. In the end we settled on these asset classes as represented by these indexes:

- ▶ Investment-Grade Bonds—Currently we use the Vanguard Total Bond Market Index Fund (VBMFX). Prior to the inception of that fund, we used the Lehman Brothers Aggregate Bond Index, and prior to that index's inception, we used the Ibbotson Intermediate-Term Government Bonds Total Return Index.
- ▶ Large-Cap U.S. Stocks—Currently we use the Vanguard 500 Index Fund (VFINX). Prior to its inception, we used the S&P 500 Total Return Index.
- ▶ Small-Cap U.S. Stocks—We currently use the Russell 2000 iShares (NAV-based) returns. Prior to its inception, we used the Vanguard Small Cap Index Fund (NAESX). Prior to its inception, we used the Russell 2000 Index, and prior to the inception of the Russell 2000 index, we used the Ibbotson Small Company Stock Total Return Index.
- ▶ Foreign stocks—We currently use the Vanguard Total International Stock Index (VGTSX). Prior to its inception, we used the MSCI EAFE Index.

It is important to note that at times we will invest in asset classes that are not included in our neutral allocation.

Neutral allocations for each portfolio type are summarized in the following table:

AdvisorIntelligence Neutral Allocations

	Risk Level (One-Year Loss Threshold)	Investment-Grade Bonds (Vanguard Total Bond Market Index)	Large-Cap U.S. Stocks (Vanguard 500 Index)	Small-Cap U.S. Stocks (Russell 2000 iShares)	Foreign Stocks (Vanguard Total Int'l Stock Index)
Conservative Balanced	-5%	60%	30%	5%	5%
Balanced	-10%	40%	40%	8%	12%
Equity-Tilted Balanced	-15%	25%	50%	10%	15%
Equity	-20%	0%	65%	15%	20%

How have the neutral allocations performed historically? The table below depicts the historical performance for our neutral allocations based on the returns of the representative indexes. We've included the S&P 500 return for a comparison to the Equity portfolio. Note that the more diversified equity portfolio outperforms the S&P 500 over the average 10-year period. *Though there is no guarantee this will continue in the future, our research covers a long time and shows that all equity asset classes have had runs of excellent relative performance—but they have always ended.*

The following table is based on returns starting with each calendar quarter beginning in 1970 and running through December 2009.

AdvisorIntelligence Neutral Allocations

Portfolio Type (as of 12/31/09)	10-Year Return (Annualized)	Standard Deviation of 10-Year Returns	Probability of Violating Loss
Conservative Balanced	4.0%	7.0%	4.1%
Balanced	3.0%	10.1%	4.5%
Equity-Tilted Balanced	2.1%	12.5%	3.8%
Equity	0.5%	16.7%	5.3%
S&P 500	-1.0%	16.1%	N/A

Step Two: Active Management—Swing at Fat Pitches

Our active asset allocation process (decisions to invest differently from neutral), emphasizes swinging only at fat pitches.

What is a fat pitch? Financial markets are quite efficient—most assets are priced fairly (based on all publicly available information) most of the time. This means that most of the time it is difficult to "out-smart" the market. However, the market does, occasionally, offer investors exceptional opportunities. Capturing a portion of the return from these opportunities, and locking them in for a full market cycle, can result in market-beating performance over a cycle. Warren Buffett puts it well when he refers to the manic/depressive nature of "Mr. Market." Despite all the information that investors have at their fingertips, *irrational greed and fear occasionally drive the market for financial assets.* It isn't the norm,

but it happens. For example, we saw both extremes in 1998. Moreover, we know extreme over-reactions can be identified. We've done a reasonably good job at this over the years. Some of the fat pitches we have hit include:

- ▶ The overvaluation of junk bonds in the late 1980s. (We got out.)
- ▶ Buying opportunities in stocks, small-caps, REITs, and junk bonds beginning in late 1990 and early 1991.
- ▶ Buying opportunities in long-term bonds in late 1994.
- ▶ Buying opportunities in REITs and Value funds in 2000.

Why swing ONLY at fat pitches? Swinging only at fat pitches is not the only way to invest successfully. However, too many investment professionals believe that investment success requires lots of activity. This is wrong. *Our discipline allows us to "swing" only when we have very strong indications that the odds are heavily in our favor because the market is not pricing rationally—a fairly rare occurrence for asset classes.* This may mean little activity in some years. Importantly, by only swinging at fat pitches (and patiently waiting for them), we minimize mistakes by not making shifts when the financial markets are not giving us a fat-pitch opportunity—not swinging when Mr. Market is neither manic nor depressive. *So, we will take action only when the markets are clearly acting irrationally. When they are rational, we won't try to make something out of nothing.* It only takes a few fat pitches over a market cycle to make a difference. *But it takes discipline and focus to have the patience to wait for the opportunity, and intestinal fortitude to act when the markets are irrational.* Successfully executing a fat-pitch strategy will add value to long-term performance relative to the neutral allocation (a successful long-term investment strategy in its own right).

How do we know a fat pitch? First, we believe it is critical to apply a consistent approach to identifying fat pitches. This is part of our discipline. Our research suggests two important factors:

1. An extreme undervaluation (or overvaluation) relative to alternative asset classes. In measuring this undervaluation, we first compare equity assets (foreign stocks, small-caps, REITs) to the S&P 500. In balanced accounts we assess equity valuations against interest rates so we can determine if there is a fat-pitch opportunity between bonds and stocks.
2. The stage of the "risk cycle" can enhance or detract from the valuation argument.

Our research strongly suggests that extreme undervaluation in a particular asset class indicates a material period of outperformance is in store in the not too distant future. Prior to implementing our more stringent definition of a fat-pitch in early 1999, we had considered asset classes when they offered a moderate (but not necessarily an extreme) valuation advantage. We now believe we cannot justify overweighting an asset class based on moderate undervaluation. Many factors may cause an asset class to appear moderately undervalued when it is not. *The fat pitches we will swing at will probably be the result of a bear market or a severe correction.* This is when the depressive side of Mr. Market shows his face, often in the form of panic selling, causing extreme undervaluation.

Also important is the stage of the economic/market cycle. For example, *if we believe we are beginning a new market cycle (or very close to it) anticipating an economic recovery, this may enhance the valuation-driven fat pitch.* Not only would this produce great valuations, but also an expected end to the fear-driven psychology that created the undervaluation. On the other hand, if we are late in the cycle, but not at the end of it, investors may continue to be cautious, avoiding the more risky assets that usually get beaten up in bear markets (economically sensitive assets and less—liquid assets—e.g. small-caps and REITs). *This makes the fat pitch slightly less attractive, but may not invalidate it totally.* Most of the time severe undervaluation coincides with a cyclical bear market when both factors are working together.

It is helpful to think of the market cycle as a risk cycle. As markets move past their early and mid-cycle strength, investors tend to temper their enthusiasm for more risky equity assets, though the enthusiasm for equities in general remains high, even growing. This leads investors to avoid less liquid or potentially more volatile asset classes. In an economic downturn, after markets have taken the cyclical hit, investors begin to anticipate a recovery and there is less of an inclination to avoid these more risky assets because of the expectation that the next downturn is a long ways off. Thus, a new risk cycle begins.

One problem is that investors may not know for sure whether a bear market marks the end of an economic cycle until after a rebound has occurred. Our discipline, which focuses on extreme undervaluation, will typically prompt us to take a slightly overweighted position in an asset class before this occurs. We would then increase exposure as we become more confident that a cycle is ending—even if valuations are not quite as good (though they would still be excellent). If we don't get to this point, we would not add to the position and would unwind it at a lower relative valuation than if we knew we were early in the cycle.

The extreme undervaluation requirement also helps us create a sell discipline that will keep us from being overweighted to most asset classes late in their cycles. Prior to the implementation of our fat-pitch discipline we had done a good job of identifying buying opportunities, but were less effective selling. Consequently, we have been developing a specific buy and sell discipline for the asset classes we follow. Though we won't follow these guidelines automatically, there must be extremely strong arguments for us to ignore a buy (increase the allocation) or sell (decrease the allocation) signal.

We also consider long-term trends and secular factors. Demographics, technological developments, global political developments and other factors may, at times impact our enthusiasm for a particular fat pitch.

When there is a fat pitch, how much will we buy or sell? This will depend on the portfolio. The more aggressive the portfolio, the wider our discretion to stray from neutral in each asset class. We're also biased toward capital preservation in our more conservative portfolios and maximizing return in our more aggressive portfolios. The allocations will also depend on whether we believe we are early in cycle, in addition to whether it is an extreme valuation opportunity. The following table indicates the asset class ranges for each portfolio.

Asset Class	Ranges ^(a)			
	Conservative Balanced	Balanced	Equity-Tilted Balanced	Equity
Fixed Income	20-90%	10-70%	0-60%	0-45%
Cash	0-25%	0-20%	0-15%	0-15%
Investment-Grade Bonds ^(b)	20-80%	10-60%	0-40%	0-25%
Foreign Bonds (Emerging Markets)	0-25%	0-20%	0-20%	0-20%
High-Yield Bonds	0-25%	0-20%	0-20%	0-20%
Equities	10-80%	30-90%	40-100%	55-100%
Domestic Large-Cap Equities	5-50%	10-60%	15-70%	25-85%
Domestic Small/Mid-Cap Equities	0-35%	0-40%	0-45%	0-50%
Foreign Equities (Developed Market)	0-20%	0-35%	0-40%	0-45%
Foreign Equities (Emerging Market)	0-15%	0-20%	0-20%	0-20%
REITs	0-25%	0-25%	0-25%	0-25%
Alternative Investments	0-45%	0-45%	0-45%	0-45%
Commodity Futures	0-20%	0-20%	0-20%	0-20%
Other Alternatives ^(c)	0-35%	0-35%	0-35%	0-35%

^(a) During transitory periods the actual asset allocations may deviate from the stated guideline ranges.

^(b) Foreign bonds of developed market countries may be included in our investment-grade bond allocation.

^(c) This category is not likely to apply to the models we publish on AdvisorIntelligence, but we include it in the investment policy statements we provide to our own clients, which is why we show it here. The category could include investments such as private real estate, hedge funds, private equity, or unconventional strategies (such as long/short), as well as currently unforeseen asset classes that emerge and attract our interest. Asset classes in this category could have limited liquidity, and no single sub-asset class within alternatives will account for more than 25% of the total portfolio.

How can we be confident there will be fat pitches in the future? Our high confidence that there will be fat pitches rests on the observation that fear and greed has always moved markets. Among other things, 1998 reminded us that these basic human emotions have not disappeared. When fear turns into panic, investors truncate their time horizons. They don't care about three years, or perhaps even three months. This reaction can create tremendous values for those with a discipline that allows them to maintain reasonable time horizons. A strong discipline, consistently applied can give us the strength to act when others allow fear to cloud their decision-making. It will be especially important to avoid swinging at bad pitches as we wait for opportunities.

Isn't this akin to market timing? No. We expect this discipline to lead us to overweight early (before a bottom) and get us back to our neutral allocation or below, early. But we have no expectations for stop on-a-dime market timing. In fact, our discipline is likely to lead us to reduce exposure far before a market peak, more often than not.

Step Three: Scenario Analysis

We use scenario analysis to assess risk exposure in each model portfolio. We consider different possible scenarios that could trigger a stock market decline. We then qualitatively assess the downside to stocks and bonds, and specifically, the individual funds we own to determine the downside exposure to the overall portfolios in each scenario. At times this analysis may lead us to be more or less defensive.

Fund Selection and Implementation

A detailed discussion of our fund research process is given in [How We Evaluate Funds](#). After we have determined which asset classes offer value, we then turn to fund selection. Choosing the right funds is important. Even within a single asset class, performance can vary widely. Occasionally fund choice alters our asset allocation strategy. If we have a very high degree of confidence in a particular fund manager, we may allocate slightly more to that manager's asset class. On the other hand, if there are no attractive funds in an attractive asset class, we may allocate less than we ideally would.

Additionally, a fund that is chosen to represent a specific asset class may not invest all of its assets there. While some asset allocation approaches would call for the sale of a fund that strayed from the style for which it was chosen, we are comfortable giving talented managers some room to move.

Our first level of fund analysis focuses on the manager's record and expenses. We are looking for long, consistent records of outperformance relative to peers. We like to have at least a five-year record, and are careful only to compare similar funds. (Returns for various style categories can differ widely, making it erroneous to draw conclusions about manager skill from comparisons of funds in different style categories.) However, as we all know, past performance is no guarantee of future returns. That's why we spend a great deal of time trying to understand managers' investment philosophies, getting to know the dynamics of the portfolio management team, and determining how successful managers have added value. We also assess managers' personal characteristics against those that our many years of experience have shown us contribute to investment success. Fund selection (like asset allocation) is a combination of art and science. Performance is a screening mechanism, but there's more to picking funds than hot records.

A number of factors influence the number of funds and the size of positions. For example, our allocations are affected by how many funds in which we have a high degree of confidence are available in a given asset class. Occasionally new funds come along that look very promising, but we already own good funds in the same asset class. In this case, rather than recommending selling all of the existing fund, we may advocate taking a small position in the new fund. If we don't have a high degree of confidence in a single manager in a specific asset class, we may use smaller positions in two funds or we may use an index fund.

When we buy a fund, we have no predetermined holding period. How long we maintain our position depends on how the asset class performs relative to its fundamentals and to other asset classes, and the continued validity of the fundamental reason for the allocation. We sell funds:

- ▶ to adjust asset allocations,
- ▶ if we lose confidence in a manager, or
- ▶ if we think there is a better alternative.

Funds we recommend as alternatives should provide similar, but not identical returns. Alternatives are suitable for clients who:

- ▶ can't meet the minimums for our first choice,
- ▶ already have positions in the alternative funds and don't want to sell for tax reasons, and/or
- ▶ can't get into funds that are closed.

Advisors use our model portfolios in a variety of ways in managing client assets. Some follow them exactly and some use them only as rough guidelines that factor in to their own models. Each subscriber has to determine how well our portfolios fit their clients' needs and risk parameters, and whether it makes sense to execute all the suggested transactions.

Conclusion

We hope this article has helped you understand the Advisor Intelligence investment process. Our discipline means taking action only when the odds of success are very high. Fundamentally, we are long-term investors looking for value in both the equity and debt markets throughout the world. After identifying "fat-pitch" asset-class opportunities, we execute our strategy using the best funds we can buy. We determine the "best" funds using a whole host of quantitative and qualitative criteria. Risk control is also critical. We manage risk probability through diversification and ongoing scenario analysis that tests for downside risk tolerance in severe sell-offs. Portfolio management is a dynamic process, calling for constant attention and adjustment at the margin to enhance returns as well as to control risk. Click here for more on [How to Use Our Models](#).