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Key Questions



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Given the market environment over the past few years, we are just not getting as many questions as we typically do on topics regarding what economic sector or fixed income asset class we prefer. Instead, we are getting deeper and quite frankly more important, philosophical questions such as:

- Considering the current volatility and long-term returns, why maintain any dedicated exposure to the stock market?
- Why maintain disciplined, balanced portfolios?
- What should an investor expect from an advisor and what value do they add?

Why Invest in the Stock Market?

Let's get philosophical and first define "investments." Investments are excess savings. This is money above and beyond basic liquid cash holdings (our general guidance for cash reserves is that an investor should maintain at least six months of living expenses -- plus additional cash to meet any major expenses in the next three years -- in a high quality cash reserve, but that number can obviously be increased due to personal reasons, including concerns about income security and stability). Capital above and beyond this basic safety net is available for long-term investing. The expectation is that in return for giving up short-term price stability and liquidity, these investments will eventually generate higher returns than cash and inflation over time.

There are various options for investments: Each has advantages and disadvantages. Investors could invest in (or even start) a private business. Investing in real estate or the stock market is also common. Clear advantages for the stock market include that it is liquid (i.e., securities can be sold quickly) and that it doesn't take as much capital to get adequately diversified.

Currently, however, the notion of owning equities is being seriously challenged. Many investors are asking why own stocks given their performance over the last ten years (even though many investors were using trailing returns less than a few years ago to rationalize more equity exposure). Like many things, stock returns tend to be cyclical, though to the stock market's credit, returns tend to be cyclical around a long-term uptrend.

Portfolios built for long-term investors are typically dominated by equities, and for good reason. Since the 1870s, the average annualized nominal return for the stock market has been over 10%. Examining rolling 12-month returns through the end of last year, returns were positive over 70% of the time. Looking at rolling 5-year returns, the stock market produced a positive return nearly 90% of the time. Over rolling 10-year periods, the stock market was up 92% of the time. While

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the stock market is not a sure thing, and it never will be of course, with historical returns and probabilities like that, maintaining some equity exposure for long-term investors – both aggressive and conservative – appears to make sense.

This is not the end of the story, of course. **Valuations** are very important for determining forward returns. In other words, the price paid for an investment is critical in determining how it will perform over time. When valuations are below average (like they are now), returns historically tend to be above-average in the future. The reverse of this also holds true, that when valuations are high, returns tend to be below-average.

Why Maintain Balanced, Diversified Portfolios?

Similar to ten years ago during the dot.com bubble, many investors are now asking why they should maintain exposure to multiple asset classes. Typically these kinds of questions point to one asset class thoroughly dominating another in a certain time-frame. Ten years ago, stocks were trouncing bonds. In the current environment, bonds are now handily outperforming stocks.

In short, we believe that balanced, diversified portfolios tend to produce the best experience for most investors. Generally speaking, investors in balanced, diversified portfolios tend to maintain a higher allocation to historically higher-returning assets over time. Balanced, diversified portfolios also help many investors minimize the tendency to sell low and buy high. This tendency to “chase performance” is arguably the most destructive investor behavior for longer-term investors. Typically, the key for investment success is not due to “timing the market, but time in the market.”

We say that balanced, diversified investment portfolios are right for “most” investors. Who are they not the best for? This depends upon the type of investor. There are two kinds of investors, at least according to the father of security analysis, Benjamin Graham. He says that there are “enterprising” and “defensive” investors. What distinguishes the two is that enterprising investors tend to be more active in their decision-making and possess the time, tools, and perhaps most importantly the temperament to consistently make investment decisions and manage a portfolio. Defensive investors are not as well-suited to investment management. Interestingly, to Graham and many other classic investors, the market wasn’t something necessarily “to beat,” it was there to serve the investor and to help them generate returns above and beyond cash holdings over time. Another interesting item about Graham is that he once wrote that all investors, irrespective of age and risk tolerance, should maintain at least 25% in stocks and 25% in bonds. The rest depended on the individual and the market.

The Value an Investment Advisor Can Provide

In a strong directional market, when volatility and emotions are elevated, many investors consider -- or question -- the use of an investment advisor. What value does an investment advisor provide? To consider the potential value added, take into account the different functions that investment advisors perform.

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First and foremost, advisors are **investment counselors**. This is arguably the most important role of an investment advisor. Working with an investment counselor is key in determining what an appropriate asset allocation may be given an investor's risk tolerance, time horizon, and other unique considerations – and how each of those factors may evolve over time. A counselor is also there to provide advice and service.

An advisor is also an **investment manager**. This is where the investment decisions are made about how to allocate a portfolio to produce an attractive rate of return. Though this is only part of what an investment advisor does, this is the part that receives the most attention. There are three ways an investment manager may attempt to add value.

First, value can be added through *strategic asset allocations*. “Strategic” means the long-term asset allocation mix a portfolio may have over a full market cycle. At Kobren Insight Management, we believe our strategic mixes are attractive as they are more comprehensive than the standard conventional mix. For example, our equity allocations go above and beyond simply using large cap stocks and developed international stocks. We also include small and mid-sized domestic stocks, as well as consistent exposure to emerging market equities. In fixed income, we don't simply use investment grade bonds, we also use other fixed income sectors including high yield bonds, inflation-linked bonds, and even international bonds. While maintaining exposure to various asset classes doesn't necessarily work in all market environments, over time such mixes typically provide historically superior risk-adjusted results.

Second, an investment manager can make *tactical asset allocation decisions*. At Kobren Insight Management, we can and will modestly shift client asset allocations based on whether we think the market is overvalued or undervalued. In recent years, for example, our portfolios were relatively defensive by our own standards (in hindsight, obviously not nearly enough) in 2008. In the first quarter of 2009, however, due to attractive valuations and other factors, our client equity allocations moved to their highest levels in years.

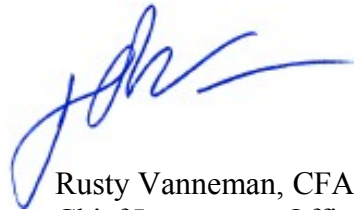
The third way an investment manager can add value is through *security selection*. In this case, at Kobren Insight Management, we have built a research infrastructure to find those mutual fund managers that can add additional value by picking better performing individual stocks and bonds in their respective market areas.

Lastly, tying the first two roles together, an advisor also serves the role of a **portfolio manager**. Managing an existing portfolio involves monitoring and managing portfolio risk. Managing a portfolio also means making disciplined decisions about portfolio re-balancing. Past studies show that regular re-balancing can add approximately 1% a year to returns. Managing a portfolio also requires supervision from a tax aware standpoint (for taxable accounts of course). Last year, and earlier this year, tax aware portfolio managers should have “harvested” tax losses to offset against past or future gains. In many cases, the expected tax benefit could have been fairly significant (one of the only advantages of a bear market).

Summary

In the end, an investor with an investment advisor should have the expectation that a portfolio is appropriately allocated (given all identified information), that returns are, at minimum, reasonable for the risks taken (and understood), and that the price is fair for the services rendered. When we analyze money managers ourselves, our top priority is not simply raw performance, but whether the management team has a disciplined process and consistent behavior. This should be the top concern of all investors.

Sincerely,



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