



WHY TACTICAL

THE NEED FOR A NEW ERA OF RISK MANAGEMENT

TRADITIONAL PORTFOLIO RISK MANAGEMENT

Diligent Security or Manager Selection



Diversification via Strategic Allocations

For portfolio managers, risk management traditionally comes from two places: “**bottom up**” diligent security selection and “**top down**” asset allocation

For investment advisors, “bottom up” security selection is replaced with manager selection, but asset allocation is still a critical component of risk mitigation

The two sources of risk management **create a system of checks and balances** that helps limit portfolio losses

A DECADE OF CRISES

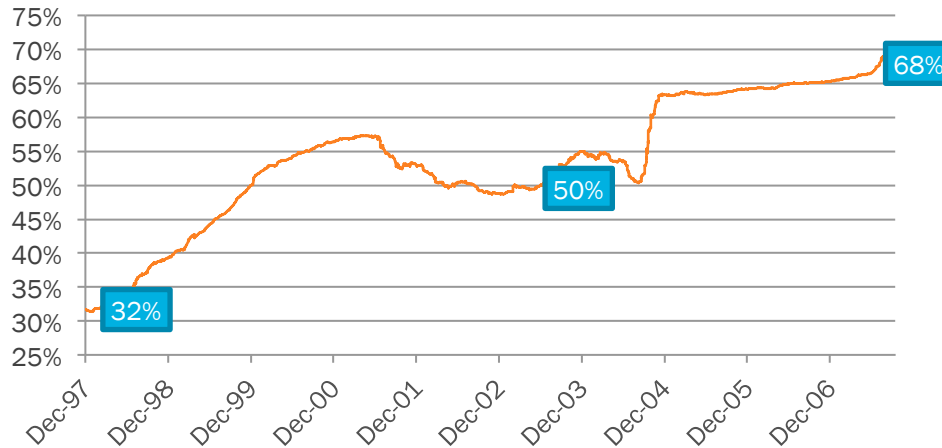
The first decade of the new century led to **approximately zero real capital appreciation** for U.S. Domestic investors with an **emotional rollercoaster ride** along the way

Even in non-crises periods, 2000-2010 was a **decade of increasing asset correlations**. Major factors include:

- Growing access to international markets for investors
- International economic markets are getting “flatter” every day; U.S. firms are now multinationals, with about 40% of profit for companies in the S&P 500 coming from overseas^[1]

INCREASING CORRELATIONS: DOMESTIC MARKETS

Rolling 3-Year Correlation



The graph to the left shows the rolling 3-year realized internal correlation of a domestic equity portfolio

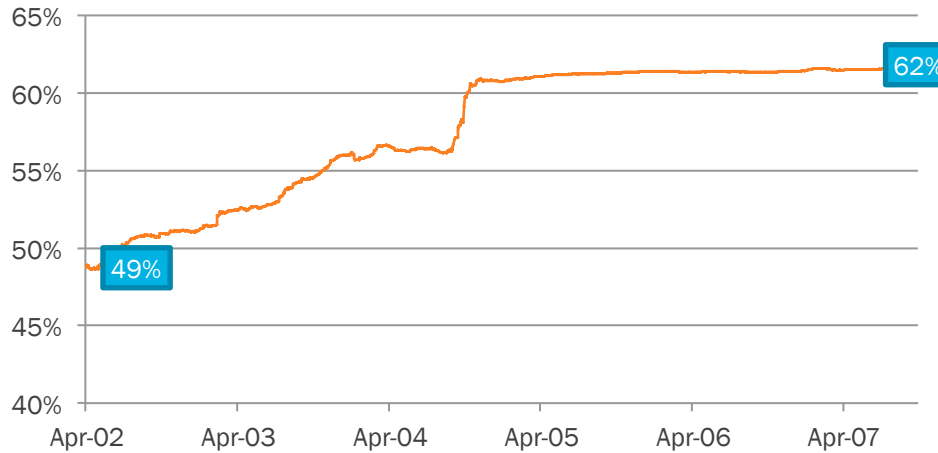
In 2001, correlation measured around 30% – by 2010, it had risen to nearly 70%; the **yearly correlation increase averaged nearly 3.6%**

An **increase in correlation represents a decrease in diversification opportunities**

Rolling 3-year realized internal correlation measure for an S&P 500 portfolio with equal weighted sectors

NOWHERE TO HIDE: INTERNATIONAL MARKETS

Rolling 3-Year Correlation



Even **diversification opportunities in international markets shrunk** in the last 5 years

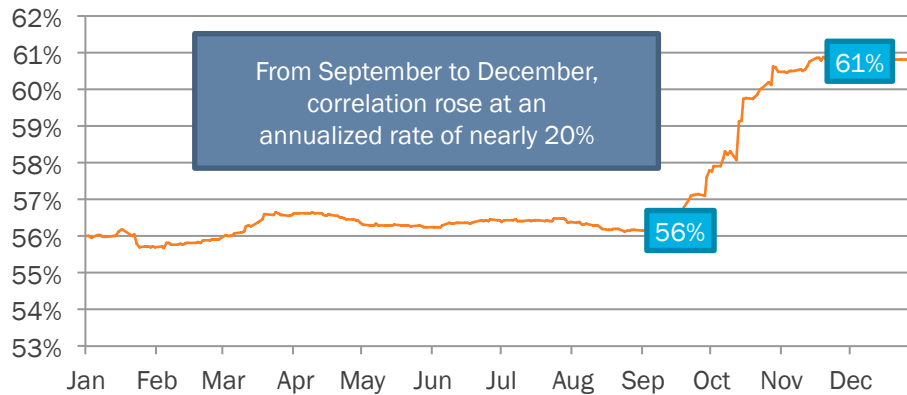
The graph to the left shows the rolling 3-year realized internal correlation of an equally weighted domestic, foreign developed, and emerging equity portfolio

In 2006, correlation measured below 50% – by 2010, it had risen above 60%; **the yearly correlation increase averaged nearly 2.6%**

Rolling 3-year realized internal correlation measure for an equally weighted domestic, foreign developed, and emerging equity

EVENT DRIVEN CORRELATIONS: 2008

Rolling 3-Year Correlation in 2008



Rolling 3-year realized internal correlation measure for an equally weighted domestic, foreign developed, and emerging equity

Psychology of Event Driven

Correlations: “[A] social contagion of ideas or emotions (causing collective euphoria or fear) leading to phenomena such as herding or groupthink”^[2]

Mathematics Behind Event Driven

Correlations: “The Unholy Trinity: Fat Tails, Tail Dependence, and Micro-Correlations”^[3]

Murphy’s Law of Diversification:

Diversification opportunities are least available when they are most needed^[4]

CORRELATIONS: AUGUST & SEPTEMBER 2011

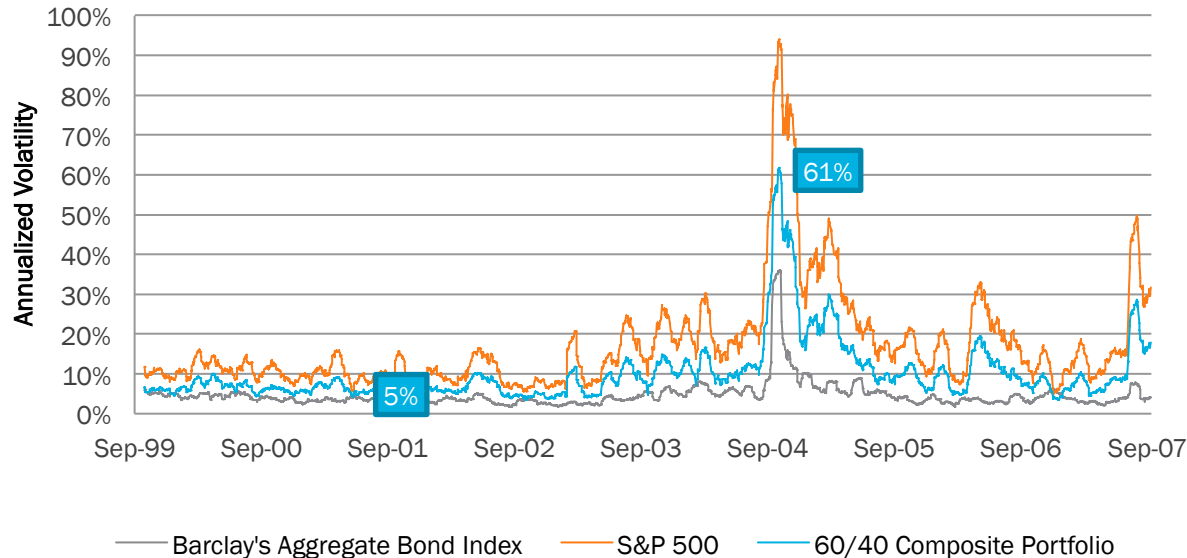
Correlations measured against the S&P 500

Name	Symbol	Current (09/09/11)	1 Month Ago (08/10/11)	2 Months Ago (07/08/11)	3 Months Ago (05/31/11)
Energy	XLE	98.09%	96.28%	88.00%	79.64%
Health	XLV	97.69%	96.51%	89.10%	82.81%
Industrials	XLI	98.91%	98.15%	95.99%	90.74%
Utilities	XLU	91.85%	93.70%	76.81%	72.14%
Consumer Staples	XLP	95.51%	95.47%	82.50%	71.07%
Telecomm	IYZ	96.99%	96.42%	90.32%	75.02%
Technology	XLK	98.48%	97.67%	94.13%	92.26%
Consumer Discretionary	XLY	98.93%	98.53%	95.31%	86.60%
Financials	XLF	96.62%	96.79%	88.01%	84.97%
Materials	XLB	98.42%	97.72%	90.75%	85.91%
<i>Average:</i>		<i>97.15%</i>	<i>96.72%</i>	<i>89.09%</i>	<i>82.12%</i>
Gold	GLD	-55.40%	-54.07%	10.77%	38.93%
Silver	SLV	-35.08%	-13.87%	39.50%	46.77%
EAFE Index	EFA	96.21%	96.72%	87.53%	92.79%
Emerging Markets	EEM	97.35%	97.89%	87.29%	86.04%
Australian Dollar	FXA	90.83%	84.32%	63.34%	75.14%
Euro	FXE	63.13%	60.48%	58.69%	72.80%
Japanese Yen	FXJ	27.17%	25.59%	-27.97%	-11.53%
High Yield Corporate Bond	HYG	89.45%	95.34%	61.89%	70.83%
Investment Grade Bond	LQD	-23.94%	7.23%	-41.05%	-21.12%

“The difference between investing in Emerging Market equities, Developed Market equities, and High Yield bonds is now effectively zero”^[5]

ASSET ALLOCATION IS NOT A RISK PROFILE

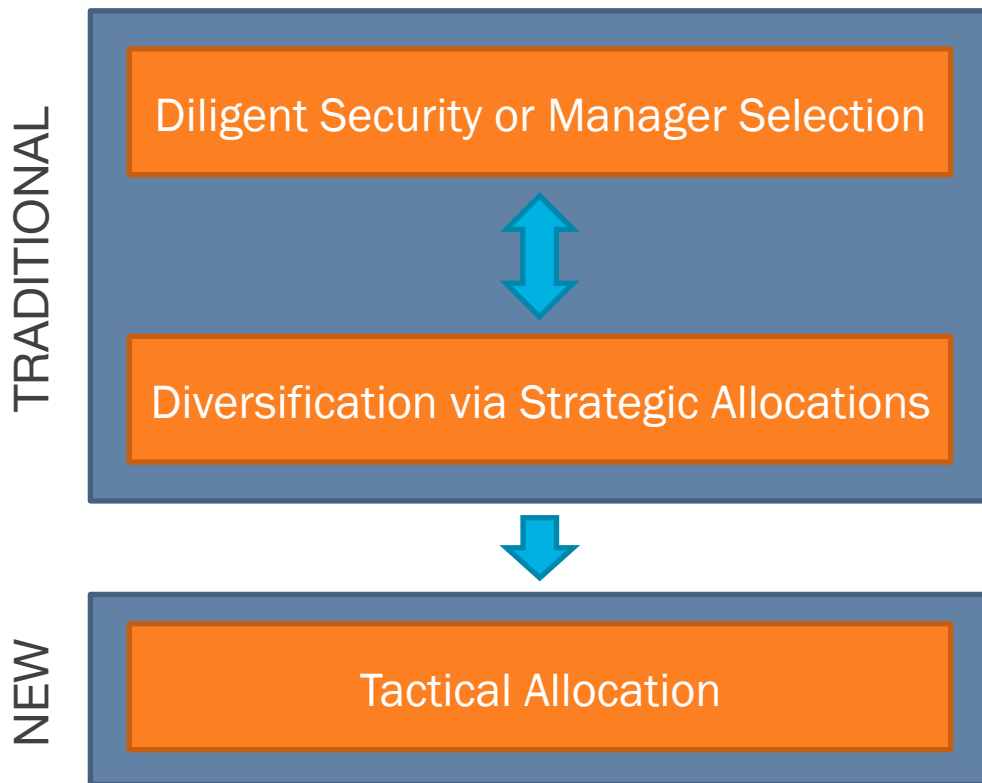
20-Day Annualized Volatility



A traditional 60/40 portfolio should not be the benchmark for a risk profile

Over the last 8 years, 20-day annualized volatility has ranged between 5% and 60%, giving “moderate” risk takers a bumpy ride in their portfolios

YOU CAN NO LONGER ALLOCATE YOUR WAY OUT OF RISK



Using a 3rd layer of risk management, managers can mitigate crisis-based risk and the loss of diversification effectiveness

Tactical asset allocation enables dynamic changes to a traditionally static allocation mix, allowing for a reduced risk profile and enhanced returns

A dynamic approach can **create a more consistent fit between portfolio behavior and investor expectations**, smoothing returns and reducing outsized losses without sacrificing return potential

RISKS OF TACTICAL RISK MANAGEMENT

MANAGING CLIENT EXPECTATIONS WITH TACTICAL PRODUCTS

Tactical Risk Management is not a free lunch. **These strategies often err on the side of safety and principal management.** While they attempt to skew upside-downside capture, there can be market cycles where they under-perform

Imagine a scenario where there is a 75% chance that markets will decrease by 50% and a 25% chance that markets will increase by 10%. Strategies focused on wealth preservation would move the portfolio into a defensive position. If the second scenario is realized, and the market rallies, then it would seem the portfolio under-performed

In the context of the decision, however, the portfolio was allocated correctly. **The realization of an event does not mean it was the most probable event at the time the allocation decision was made. Allocation decisions must be examined in the context in which they were made and not with the bias of hindsight**

DISCLOSURES & CITATIONS

CITATIONS

- [1] – Why U.S. Companies Aren't So American Anymore. On U.S. News. Retrieved October 8th, 2011, from <http://money.usnews.com/money/blogs/flowchart/2011/06/30/why-us-companies-arent-so-american-anymore>
- [2] – Behavioral economics. In Wikipedia. Retrieved October 1st, 2011, from http://en.wikipedia.org/wiki/Behavioral_economics
- [3] – Kousky, Carolyn and Cooke, Roger M., The Unholy Trinity: Fat Tails, Tail Dependence, and Micro-Correlations (November 9, 2009). Resources for the Future Discussion Paper 09-36-REV. Available at SSRN: <http://ssrn.com/abstract=1505426>
- [4] -- Li, Lingfeng, Macroeconomic Factors and the Correlation of Stock and Bond Returns (November 2002). Yale ICF Working Paper No. 02-46; AFA 2004 San Diego Meetings. Available at SSRN: <http://ssrn.com/abstract=363641>
- [5] -- Financial Times, FT AlphaVille, Cardiff Garcia, Retrieved on September 13th, 2011, from <http://ftalphaville.ft.com/blog/2011/09/13/676156/fire-your-adviser/>

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