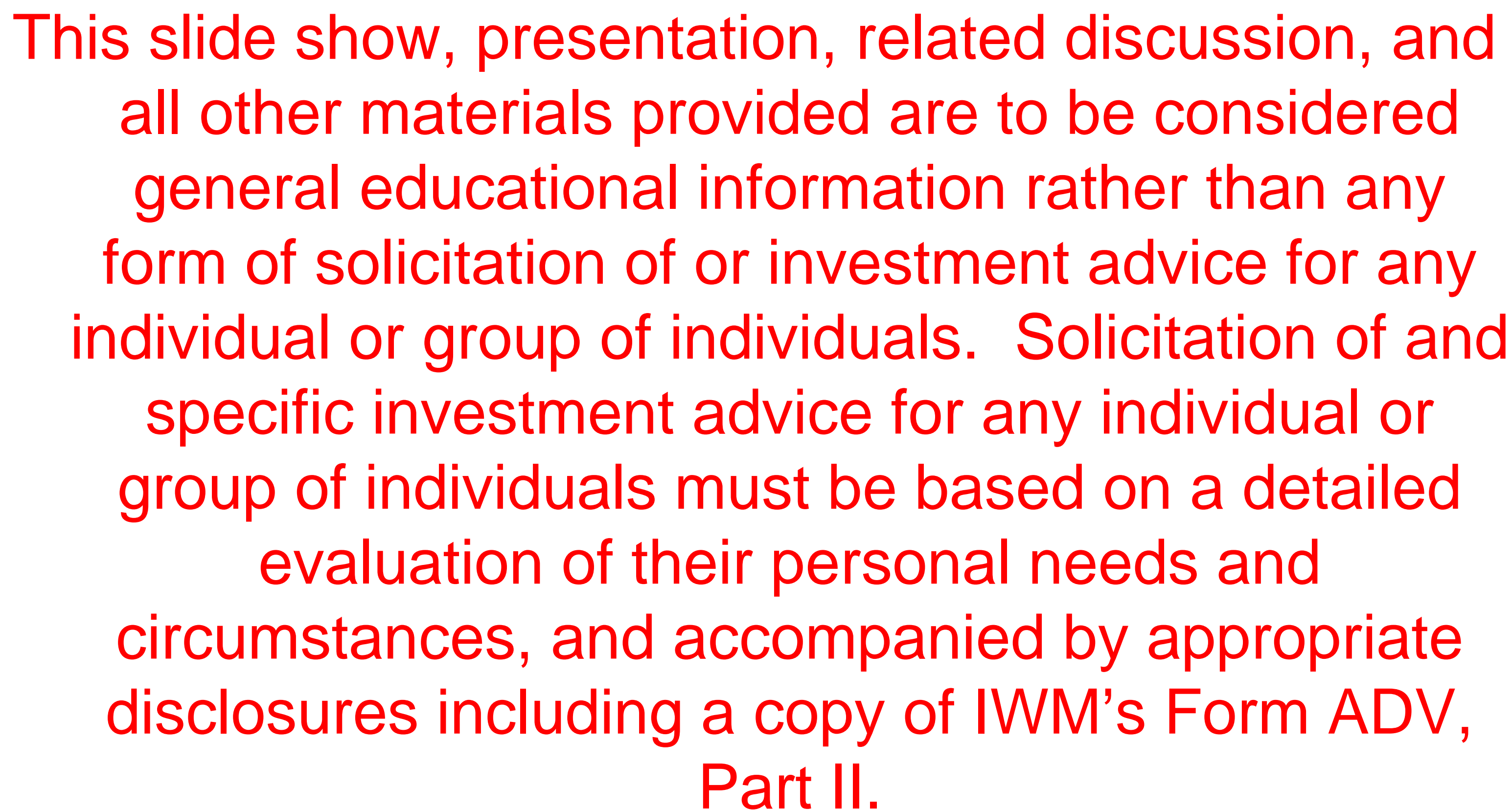
INSIGHT
WEALTH
MANAGEMENT

The Portfolio Perspective

Presented by Bob Pugh, CFA

President, Insight Wealth Management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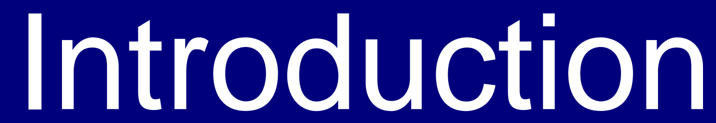
Bob Pugh, CFA Brief Biography

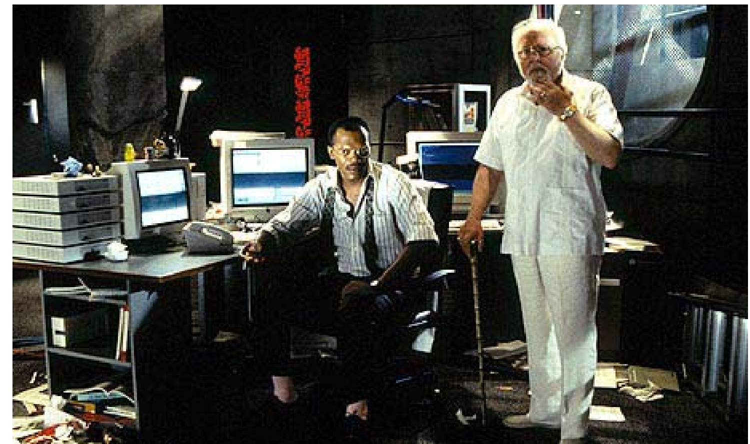
- President; Insight Wealth Management in Gainesville, VA, providing independent wealth and investment management services to individuals, families and charitable organizations. Member of the Schwab Institutional network of select independent advisors
- President of the CFA Society of Washington, DC, 2005 to 2007
- Eastern Region Presidents Council Representative, CFA Institute, term beginning September 2009
- Over twenty years of experience as a financial educator and analyst, and portfolio manager, including the Central Intelligence Agency, director of investment research, and senior financial analyst with the Prince William County government.
- Advised and managed investment portfolios for individuals and endowments for over ten years
- Graduate degrees in global political economy from the Johns Hopkins University, School of Advanced International Studies, and in financial economics from the University of North Carolina at Greensboro
- Faculty member; Johns Hopkins University's Carey School of Business teaching graduate-level courses in investment analysis, portfolio management, and corporate finance since 2001
- Volunteer; President of the Prince William Symphony Orchestra and over ten years service with the Prince William County Personal Finance Program
- Contact information available at www.insightwealth.com

- Introduction
- The Traditional Approach to Risk, Diversification and Asset Allocation
- Risk – Reality Rather than Textbooks
- A Methodical Approach to Investing - The Portfolio Perspective


Introduction

The Portfolio Perspective - Risk

- What do “Jurassic Park” and construction of investment portfolios have in common?



- What do “Jurassic Park” and construction of investment portfolios have in common?
- Non-linear dynamics, complexity, chaotic systems, unpredictability
- Traditional financial models and measures of risk assume constant relationships among variables
- Assessing your risk tolerance is the most important step in constructing a portfolio
- What is investment risk?

The Traditional Approach to Risk, Diversification and Asset Allocation

Risk

- Traditional measures of risk include variance, standard deviation, beta, etc.
- Still important because they provide consistent measures to compare investments and portfolio performance
- These measures are necessary but not sufficient

Diversification and Asset Allocation

Diversification - Having enough securities in a portfolio, or allocation to an asset class, to produce the market’s risk and return without excessive exposure to the risk of any individual security

Asset Allocation - Structuring a portfolio to include diversified exposure to various asset classes to achieve the portfolio’s return and risk objectives

Risk - (exhibit from Malkiel)

Selected Performance Statistics, 1926–97

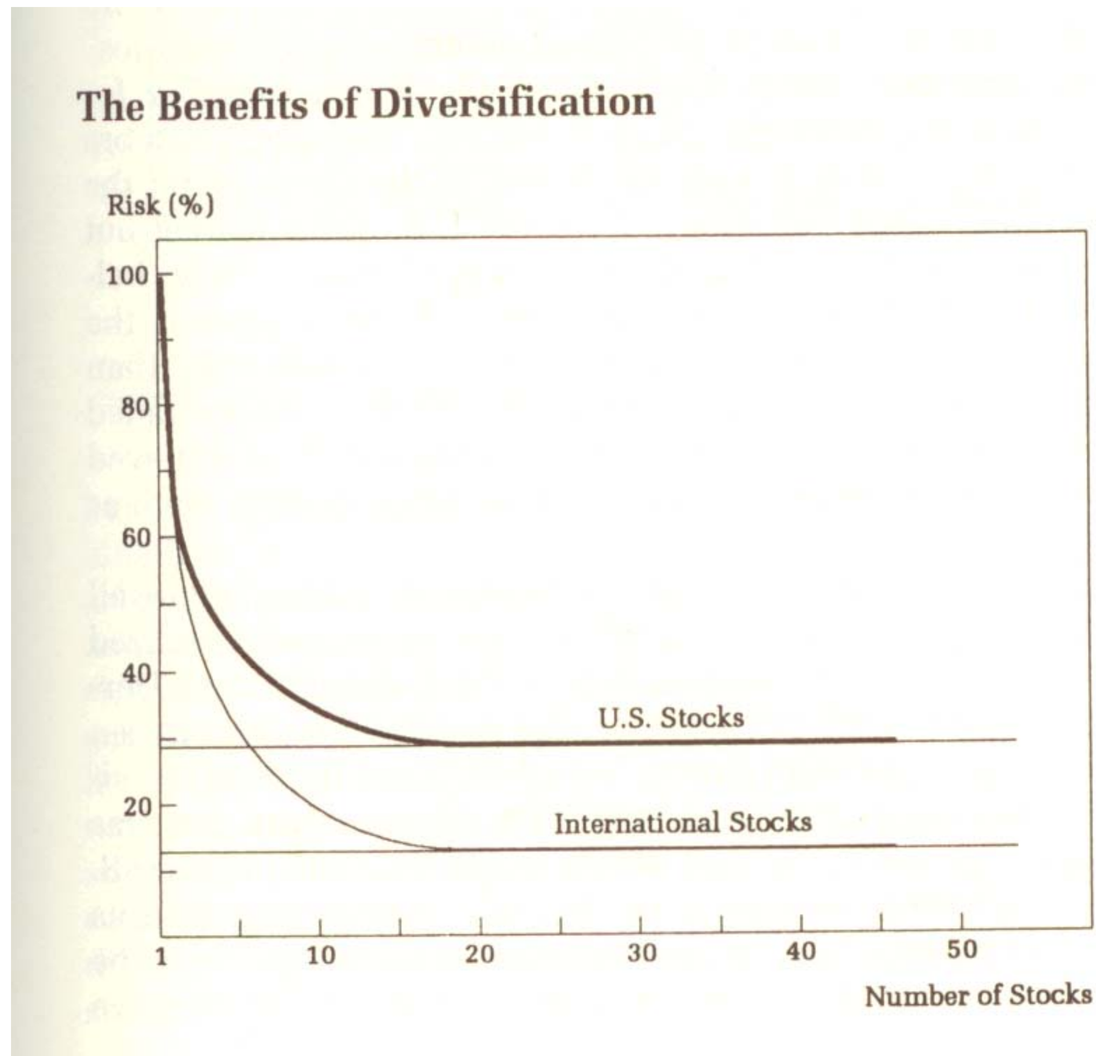
Series	Geometric Mean	Arithmetic Mean	Standard Deviation	Distribution
Large-company stocks	11.0%	13.0%	20.3%	
Small-company stocks[a]	12.7	17.7	33.9	
Long-term corporate bonds	5.7	6.1	8.7	
Long-term government bonds	5.2	5.6	9.2	
Intermediate-term government bonds	5.3	5.4	5.7	
U.S. Treasury bills	3.8	3.8	3.2	
Inflation	3.1	3.2	4.5	

–90% 0% 90%

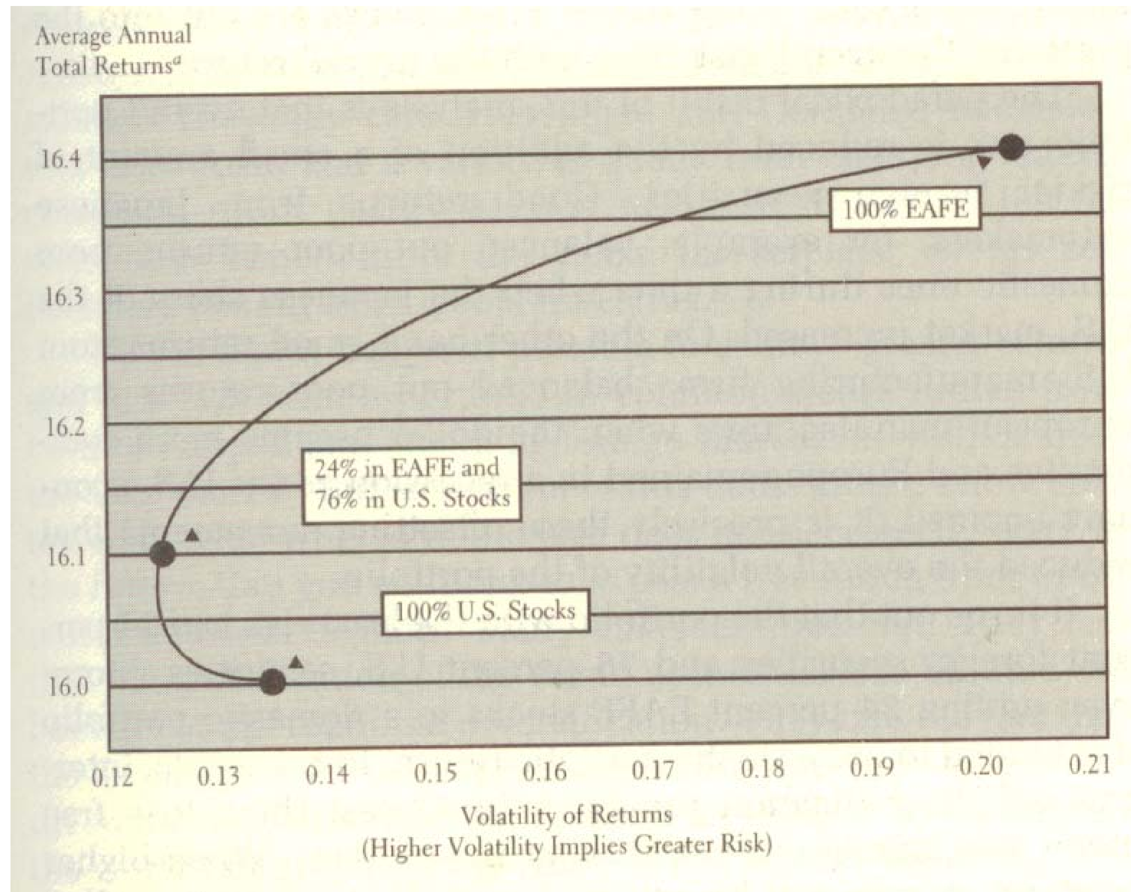
Source: Ibbotson Associates.

[a] The 1993 small-company stock total return was 142.9 percent.

Diversification - (exhibit from Malkiel)



Asset Allocation and the Efficient Frontier
(exhibit from Malkiel)



- Asset allocation at the macro level (cash, fixed-income and equity) is a key risk management tool
- Asset allocation at the micro level (various categories of equity) can be used to boost long-term return and reduce risk (variance)
- Combine asset classes with low correlations
- Must be based on forward-looking analysis, not historical relationships and trends

Examples of ETFs

(not a recommendation to invest)

ETF	Description	Asset Class	Asset Class Diversification	Increased Expected Long-Term Return	Inflation Hedge	Ticker	Net Expense Ratio
iShares S&P 500 Index Fund (Core Equity Holding)	S&P 500 Index	US Equity	No	No	No	IVV	0.09%
Vanguard High Dividend Yield ETF (Core Equity Holding)	High-Dividend, Blue-Chip		No	No	No	VYM	0.25%
iShares Russell 2000 Index Fund	Small Cap		No	Yes	No	IWM	0.24%
Vanguard Financials ETF	Financial Sector		No	Yes	No	VFH	0.25%
iShares MSCI EAFE Index Fund	Developed Market	Internantional (non-US equity)	Yes	No	No	EFA	0.34%
Vanguard Emerging Markets ETF	Emerging Market		Yes	Yes	No	VWO	0.27%
iShares Cohen & Steers Realty Majors Index Fund	US	Real Estate	Yes	Yes	Yes	ICF	0.35%
iShares FTSE EPRA/NAREIT Developed RE ex-US Idx Fd	International		Yes	Yes	Yes	IFGL	0.48%
iShares S&P Global Materials Sector Index Fund	Commodities	Commodities	Yes	No	Yes	MXI	0.48%
Vanguard Energy ETF	Energy	Energy	Yes	Perhaps	Yes	VDE	0.25%

IWM Investment Performance

Insight Wealth Management, Inc. 2006 - 2008 Portfolio Performance Report

	2006 Total Return	2006 Risk*	Sharpe Ratio**	2007 Total Return	2007 Risk*	Sharpe Ratio**	2008 Total Return	2008 Risk*	Sharpe Ratio**
IWM Actual Portfolio (total AUM) ***(total assets under management net of all fees and expenses)***	14.40%	2.50%	4.31	7.15%	2.63%	1.48	-30.05%	6.50%	NA

Performance of Benchmarks

	2006 Total Return	2006 Risk*	Sharpe Ratio**	2007 Total Return	2007 Risk*	Sharpe Ratio**	2008 Total Return	2008 Risk*	Sharpe Ratio**
1-Month T-bill ***(gross of fees)***	4.85%	0.08%	NA	4.49%	0.18%	NA	1.30%	0.21%	NA
(net of .30% hypothetical quarterly fees)	3.61%	0.08%	NA	3.26%	0.18%	NA	0.09%	0.21%	NA
Moody's AAA Yield ***(gross of fees)***	5.73%	0.06%	NA	5.70%	0.04%	NA	5.78%	0.04%	NA
(net of .30% hypothetical quarterly fees)	4.49%	0.06%	NA	4.45%	0.04%	NA	4.54%	0.04%	NA
S&P 500 ***(gross of fees)***	15.80%	3.63%	3.02	5.50%	3.97%	0.25	-37.00%	8.10%	NA
(net of .30% hypothetical quarterly fees)	14.46%	3.63%	2.99	4.25%	3.97%	0.25	-37.84%	8.10%	NA

IWM Asset Allocation

2006 IWM Portfolio Actual Average Asset Allocation

	Percent Allocation
Cash	4%
Fixed-Income	33%
Equity	63%
Total	100%

2007 IWM Portfolio Actual Average Asset Allocation

	Percent Allocation
Cash	15%
Fixed-Income	21%
Equity	64%
Total	100%

2008 IWM Portfolio Actual Average Asset Allocation

	Percent Allocation
Cash	10%
Fixed-Income	21%
Equity	69%
Total	100%

Notes to IWM Portfolio Performance Report:

AUM means "assets under management." The IWM portfolio performance information presented here includes all assets for which IWM has discretionary authority or provided investment advisory service.

Past performance is not a guarantee of future performance. Each client's portfolio performance will vary based upon their tolerance for investment risk and individual investment strategy, which is structured to reflect that risk tolerance.

****Risk is measured as the standard deviation of returns.***

*****The Sharpe ratio measures investment return relative to the amount of risk taken to achieve that return. A higher Sharpe ratio indicates better risk-adjusted portfolio performance.***

Risk – A More Practical Approach

Risk – Jurassic Park Again

- In the second Jurassic Park film, “The Lost World” Hammond tries to convince complexity theory mathematician Ian Malcolm to venture into his dinosaur world a second time saying, “Don’t worry. I’m not making the same mistakes again.” Malcolm responds, “No, you’re making all new ones.”

Risk

Peak	Trough	Contraction	Expansion	Cycle		Catalyst
		Peak to Peak	Previous Trough to This Peak	Trough from Previous Trough	Peak from Previous Peak	
November-73	March-75	16	36	52	47	Oil Prices, Politics
January-80	July-80	6	58	64	74	Fed Policy
July-81	November-82	16	12	28	18	Fed Policy
July-90	March-91	8	92	100	108	Oil Prices, S&L Crisis
March-01	November-01	8	120	128	128	Tech Bubble Burst
December-07			73		81	Housing & Credit Markets

Risk

- We will probably never see another recession or bear market brought about by an S&L crisis, IT bubble collapse or housing bubble collapse
- The catalyst for the next recession/bear market is something none of us are now thinking about much, or not at all

Risk

- Variables and relationships among variables are not constant. That includes return, standard deviation and correlation.
  - Short-term fluctuations and changes
  - Long-term structural change
  - Economic and market conditions
- Changes can not be predicted
- The efficient frontier is very sensitive to inputs of these measures. Since they can never be determined precisely and are in a constant state of change, the efficient frontier and any resulting asset allocation is a theoretical exercise rather than a practical tool for investing.

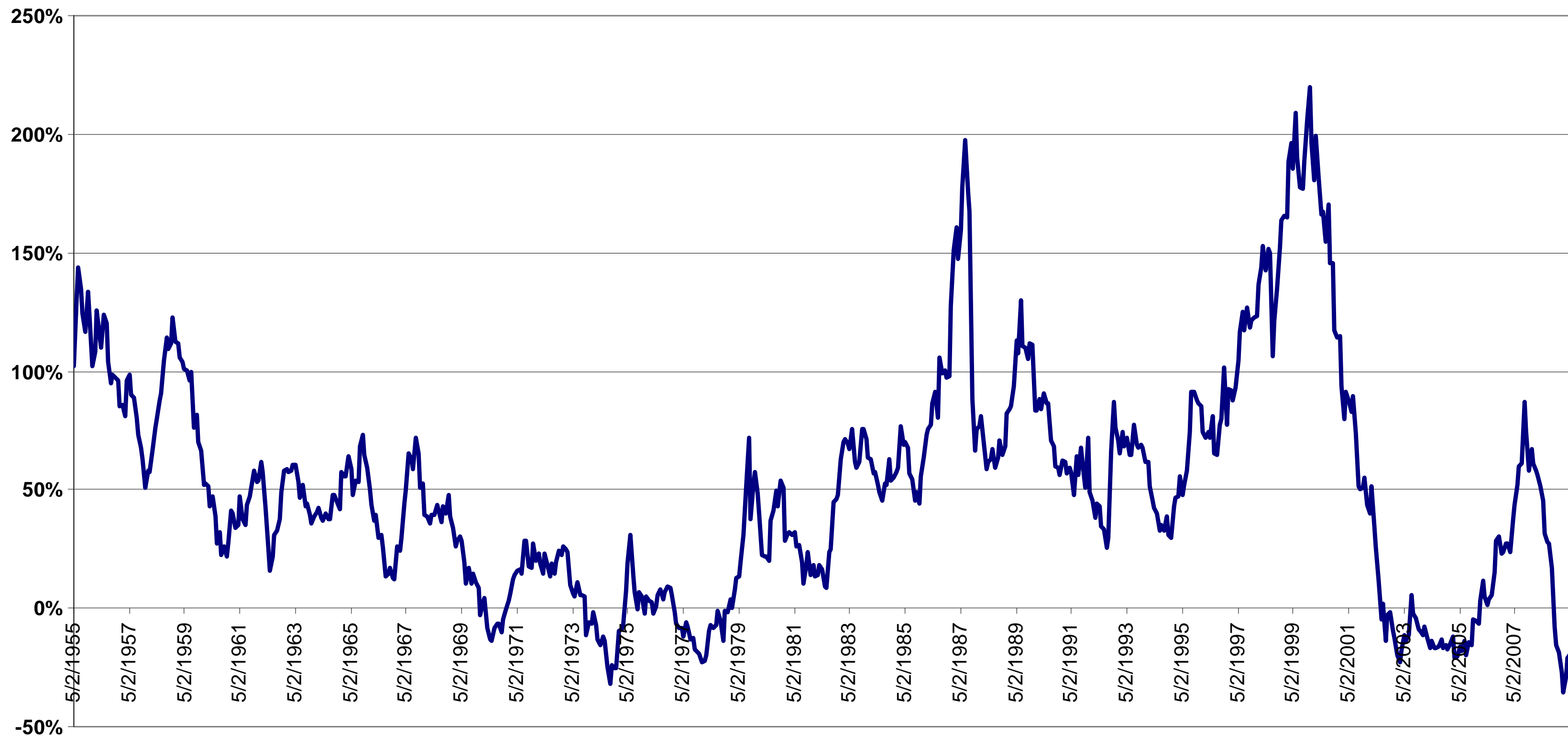
Risk

- Lao Tzu , a 6th century BC Chinese philosopher observed,
  - “Those who have knowledge don't predict. Those who predict don't have knowledge.”
  - “Anticipate the difficult by managing the easy.”

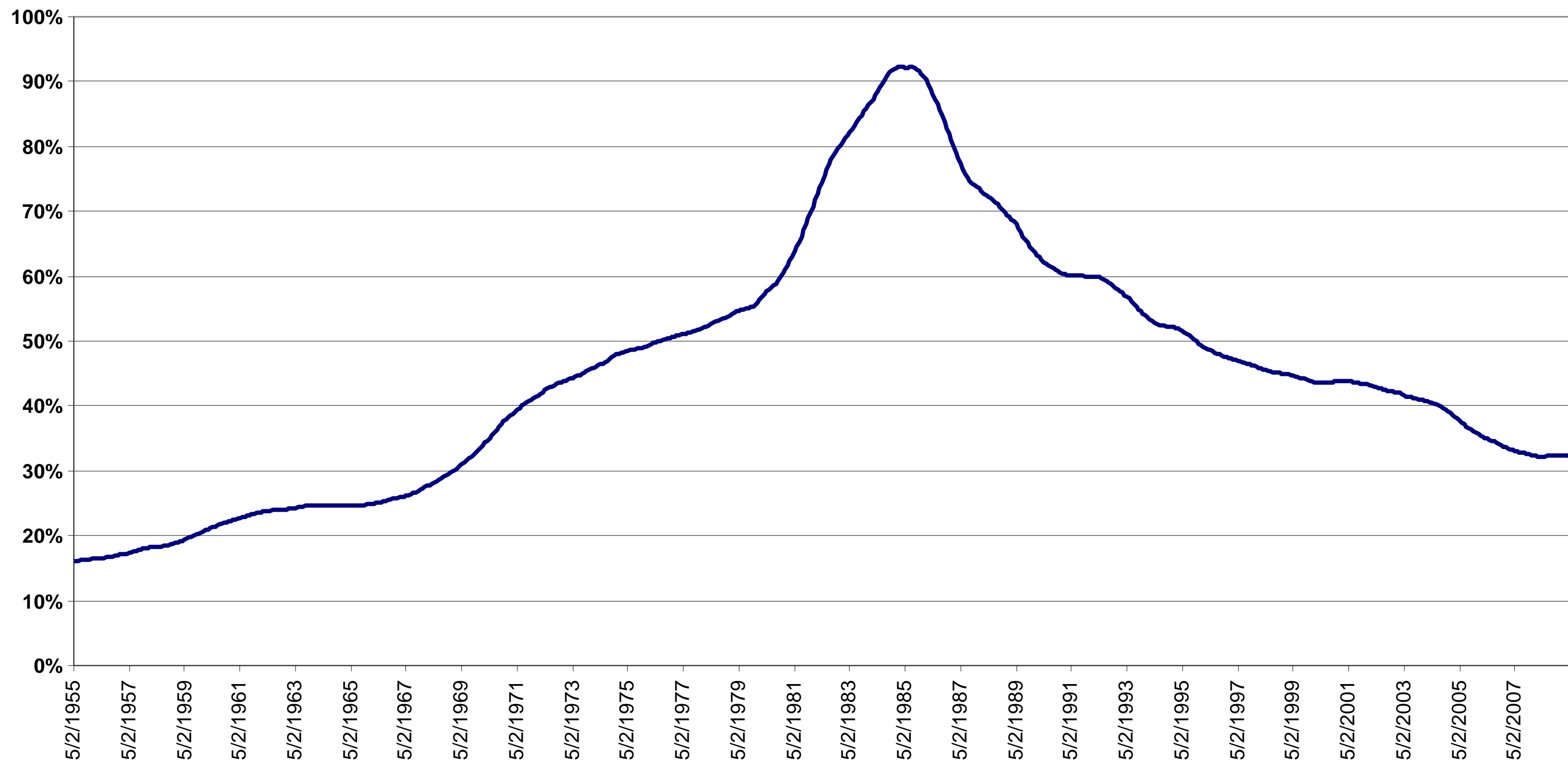
Risk

- Taleb's "Black Swan" is a highly improbable event that has three features:
  - Unpredictable
  - Massive Impact
  - After it occurs, people rationalize it so that it appears less random and more predictable
- Taleb rejects completely mean-variance analysis and other traditional measures of risk
- Probability of any given Black Swan event is incredibly low but chances of some Black Swan, whatever it may be, are much higher

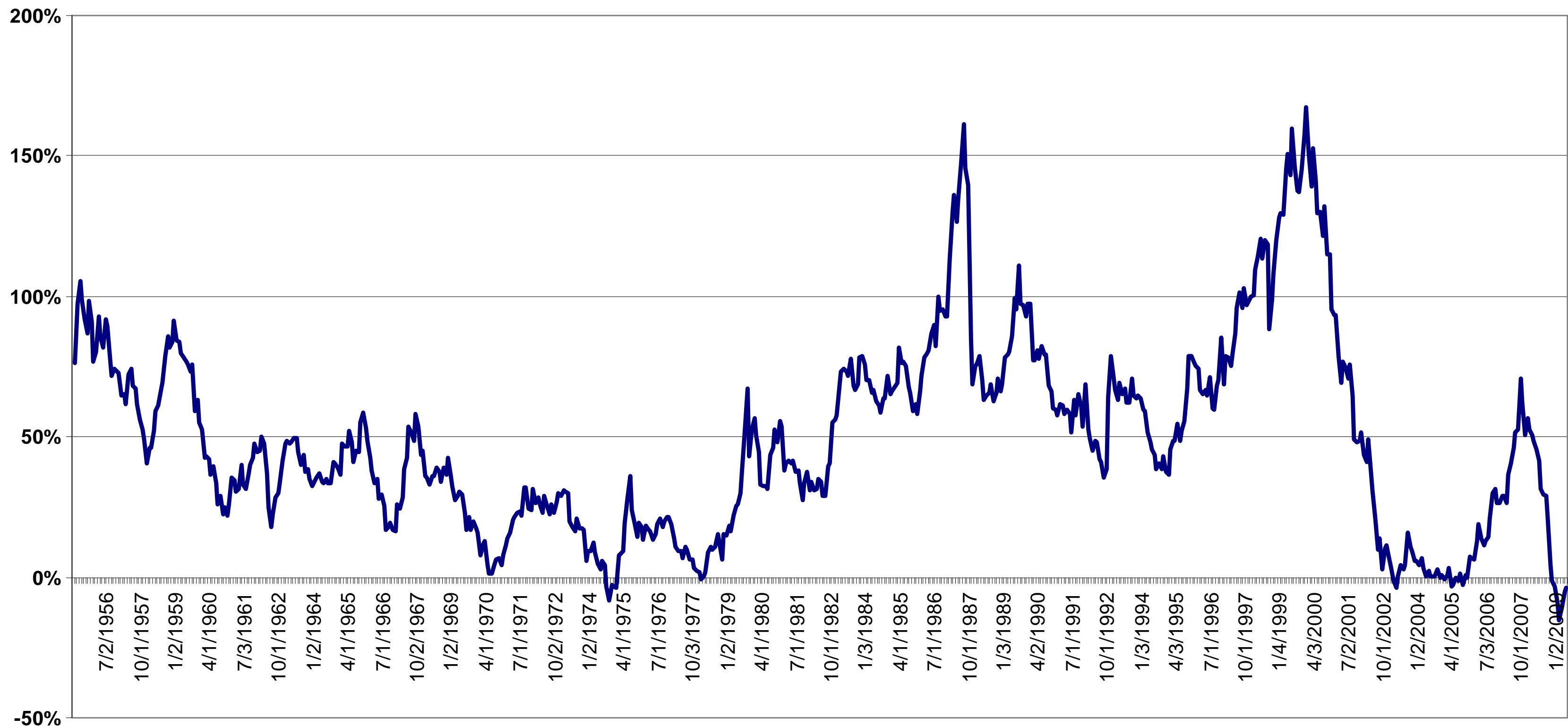
S&P 500 Five-Year Return



Moody's AAA Bond Index Five-Year Return



70% S&P 500 30% AAA Bond Allocation Five-Year Return



A Methodical Approach to Investing – The Portfolio Perspective

What are the Problems Here?

What are the Problems Here?

Inadequate Planning

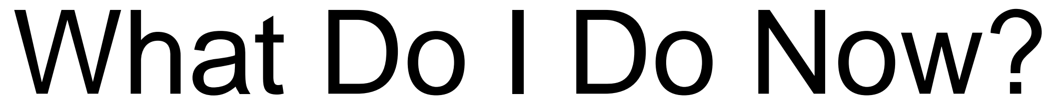
(not enough life boats)

“Don’t Worry, Be Happy” attitude

(Titanic can’t sink – enjoy yourselves!)

Trusting People Who Shouldn’t be Trusted

(Company executives and others putting their interests ahead of passenger safety)



- Investors have taken a hit in the recent market crash
- Those with a well thought-out plan for the long haul that reflects their ability to take investment risk are OK
- For those who did not have a plan, there's no way to undo damage already done
- It’s never too late to plan, invest methodically, and move forward

Many Investors Can’t See the Forest (their portfolio) for the Trees (stocks, mutual funds and other investment vehicles)

The Portfolio Management Process

- Determine the Portfolio’s Objectives
- Develop an Investment Strategy to Achieve those Objectives
- Implement the Investment Strategy (i.e., select securities)
- Monitor and Measure Portfolio Performance
- Rebalance and Modify as Needed

The two most important dimensions of portfolio performance, ***risk and return***, are determined by the interaction of the investments in the portfolio rather than the characteristics of the investments by themselves

Forest versus Trees!

Investor's First Portfolio Objective -
Determine how much investment risk they can tolerate based on their own ability and willingness to take risk

Investor's Second Portfolio Objective -
Structure their portfolio to generate an acceptable level of return without exceeding the risk threshold

Determining Long-Term Portfolio Strategy

Long-Term Investment Policy and Strategy is Governed by:

Objectives:

- Risk
- Return

Constraints:

- Liquidity Needs
- Time Horizon
- Current Wealth
- Current and Expected Income
- Legal and Regulatory Factors
- Taxes
- Other Considerations

Let’s Assess Your Ability to Withstand Investment Risk and Construct an Asset Allocation!

Write Down Your Answers to the Questions On the Next Slide

Determining Long-Term Portfolio Strategy

- How much do you have in investable assets?
- Figure that you need at least six months of income in reserve in liquid assets in case of financial emergencies. How much is that?
- How much of your investable assets will you need more than one but less than five years from now?
- How much of your investable assets will you need more than five but less than ten years from now?
- How much of your investable assets will you need more than ten years from now?

Determining Long-Term Portfolio Strategy

Rules of Thumb for Asset Allocation

- **Liquid, Safe Assets Such as FDIC-Insured Accounts** - Six months of income in reserve and funds to meet annual expenses
- **Short-Term, High-Grade Fixed-Income** – Funds you will need more than one but less than five years from now (short-term bond/CD ladder)
- **Higher Yielding Fixed-Income or Conservative Equity** – Funds you will need more than five but less than ten years from now
- **Relatively More Aggressive Equity and Other Investments** - Funds you will need more than ten years from now

Determining Long-Term Portfolio Strategy

Your Long-Term Portfolio Strategy

Adjust the rule-of-thumb allocation for your willingness to take investment risk (psychological)

For a more aggressive strategy seeking greater return for risk tolerant investors, increase allocations to equity asset classes

For a less aggressive strategy for less risk tolerant investors, increase allocations to less volatile fixed-income asset classes and decrease allocations to equity asset classes

Determining Long-Term Portfolio Strategy

Rules of Thumb for Asset Allocation

- Greater current and expected income, especially as income exceeds that needed for basic expenses, enhances your ability to take investment risk
- Greater current wealth enhances your ability to take investment risk

(from Maginn, Tuttle, Pinto and McLeavey)

- Source of Wealth
- Measure of Wealth
- Stage of Life
  - Foundation
  - Accumulation
  - Maintenance
  - Distribution

Investor Personality Typing

(from Maginn, Tuttle, Pinto and McLeavey)

	Decisions Based Primarily on Thinking	**Decisions Based Primarily on Feeling**
More risk averse	**Methodical**	**Cautious**
Less risk averse	**Individualist**	**Spontaneous**

Determining Long-Term Portfolio Strategy

Return Objective

- The return objective is based on achieving personal financial goals such as retirement, education of children, philanthropy, leaving an inheritance, or whatever else the investor might choose

- The return objective must be consistent with the risk objective. Taking more risk in the portfolio than the investor can tolerate can lead to disaster

- If a portfolio can’t achieve desired goals without exceeding the risk tolerance, the personal financial goals and return objective must be revised

Determining Long-Term Portfolio Strategy

Other Considerations

Everyone has their own particular needs and considerations that should be reflected in their portfolio strategy. These include the desire to avoid socially-objectionable investments, provide financial support or inheritances, philanthropy, and many others.

Determining Long-Term Portfolio Strategy

Tax Efficiency

- Use tax-deferred accounts as much as possible, and put assets that would generate the most short-term tax liability in them
- Use tax-exempt securities such as municipal bonds where appropriate
- Minimize portfolio turnover and realization of capital gains
- Have an estate plan to transfer assets with minimal tax impact
- Consult your accountant or financial advisor for other suggestions

Strategies and Methods

Taking the Portfolio Perspective is Important Whatever Your Approach to Investing

- Passive - Index exposure to various asset classes through ETFs and index mutual funds
- Active - Various strategies such as market timing and stock picking that attempt to “beat the market”
- Fundamental – Analyze the fundamental characteristics of an investment expenses
- Technical – Analyze patterns in market data

Impact of Fees

Assume an initial investment of $250,000 that earns a gross annual return of 10% for ten years:

Annual Expense Ratio	Total Fees Paid	Ending Portfolio Value
3.00%	$ 112,383	$ 492,961
2.50%	$ 96,117	$ 516,307
2.00%	$ 78,923	$ 540,632
1.50%	$ 60,759	$ 565,969
1.00%	$ 41,582	$ 592,357

Suggestions for Further Reading

- “Unconventional Success: A Fundamental Approach to Personal Investment,” by David F. Swensen. Free Press
- “A Random Walk Down Wall Street: The Time-Tested Strategy for Successful Investing,” by Burton G. Malkiel. W. W. Norton
- “Common Sense on Mutual Funds,” by John C. Bogle. John Wiley & Sons, Inc.
- “The Little Book of Common Sense Investing,” by John C. Bogle. John Wiley & Sons, Inc.
- “Against the Gods” and “Capital Ideas Evolving,” by Peter L. Bernstein. John Wiley & Sons, Inc.
- “Managing Investment Portfolios: A Dynamic Process,” by Maginn, Tuttle, Pinto and McLeavey. CFA Institute
- “The Black Swan” and “Fooled by Randomness, by Nassim Nicholas Taleb. Random House”