# CONSIDERING DIVERSIFICATION

- Our options for further enhancing diversification within our portfolios are growing. As we've augmented the portfolios, we've received a greater number of queries in re: our incorporation of various asset classes into the mix. This month's commentary addresses some of those questions, as we try to share some of the reasoning behind portfolio diversification decisions.
- Generally speaking, our portfolios are designed with a risk-managed, benchmark-relative positive excess return both from income and capital gains in mind. And that motivation necessitates a heavier weight on the stabilizing effects of income over the potentially volatility boosting effects of a focus on capital gains.
- The correlation of high-yield ETFs with various equity classes, while high at times but not always, is spurious in our view, and belies the fact that high-yield debt represents an entirely different claim on the underlying assets of the companies that carry such debt, one very much senior to that of the equity classes. And in that more senior claim, particularly in times such as these, a sound case can be made that the high-yield fixed income class is a far more sensible way to invest in the corporate sector than equities.
- As has been the case with high yield over the past two years, the return per unit of risk for high yield, REITs and gold has exceeded that of large-cap equities.
- Core to our methodology is an emphasis on the portfolio-level stability generally supported by income and a focus on self-relative valuation metrics. Importantly, the dynamic does not specifically favor fixed income over equity.
- Often on these pages and in our conference calls we discuss what would seem to be more qualitative measures. We do this because it's a more credible, tangible and efficient manner to translate what we are seeing in our analytical framework into real-world events and considerations. Further, it is very much our charge, having been entrusted with others' funds, to filter the political landscape into implications for the capital markets. Just so happens that over the past two years we've been narrating political events far more often than might have been expected in more stable markets— in our minds rightfully so and with positive net effect on portfolio performance.

## CONSIDERING DIVERSIFICATION

What's been true in the equity exchange-traded fund (ETF) space for some time now is becoming increasingly evident in the fixed income sector: providers are expanding the investment opportunity set by providing more granularity in terms of asset class coverage. Even more, ETF managers have been slowly adding exposures to non-traditional asset classes (many may read this to mean segments other than equity or fixed income). And that means our options for further enhancing diversification within our portfolios are growing. As we've augmented the portfolios—in some cases with a broader mix of asset classes and with other moves a narrowing of focus within existing allocations—we've received a greater number of queries in re: our incorporation of various asset classes into the mix. This month's commentary addresses some of those questions, as we try to share some of the reasoning behind portfolio diversification decisions.

## OPPORTUNITIES GROWING

Turn back the clock a few years and the only viable fixed income investments represented by equity exchange-traded funds (ETFs) were the Aggregate—which measures the U.S. investment-grade, fixed-rate, taxable bond market and include Treasuries, government and corporate securities, in addition to mortgage-backed and asset-backed securities —and a select few slices of the U.S. Treasury market. With the launch this past week of a few non-U.S., country-specific ETFs, the opportunity set within the fixed income realm has expanded to 116 names, according to research firm Morningstar, and encompasses a wide swath of U.S.- and U.S.-dollar-focused, global corporate and sovereign, regional corporate and sovereign and, now, country-specific funds[1].

Folks often seem surprised to find a portfolio not chock-full of one-way bets. Frequent in our past conversations are questions like, "If you think interest rates are going to rise, why aren't you fully invested in the short-end of the yield curve?" The vice-versa is easily as common, as are any manner of portfolio-minded extrapolations from particular investment takes we've expressed. Also common, "Everyone says rates are going to rise, why do you own any fixed income at all?" or, "With such bearishness in mind, isn't cash a better place to be?"

The answer to each is, "Perhaps." Except for that last one, actually. If increasing turmoil is the expectation—and if the past few years of gyrations are any indication—we are better served in the Treasury space than we are in cash. Meantime, we can't be sure of the net influence of any particular source of turmoil, so spreading our bets is the more prudent approach. Here's the thing: we

[1] We have written extensively on this topic, including a forthcoming piece: An Empirical Analysis of Exchange Traded Funds, Journal of Portfolio Management, Gerald W. Buetow and Brian J. Henderson.

can only know the best allocation well after the fact, as we never can be sure that any particular positioning will prove prescient. And even if eventually we're proved correct on a particular notion, the ride to that proof may well be more than a bit wild. And near for sure, exactly at the point when, "everyone is saying…" is that point at which the opposite tack should seem more appropriate.

So in the event we're not so accurate in our expectations (those findings predominantly driven by our quantitative investment framework…a topic we'll review later), or otherwise untimely in our implementation of portfolio shifts, we incorporate various elements of 'friction' into our portfolios to attempt to ensure that any one position doesn't prove overly detrimental to portfolio performance. Such efforts should not be seen as a compromise. Rather, they should be seen as a recognition that markets are mostly unpredictable, and that often the best course is one that's not so specifically charted. Sure, that same friction may cap the maximum potential upside. But, generally speaking, our portfolios are designed with a risk-managed, benchmark-relative positive excess return both from income and capital gains in mind. And that motivation necessitates a heavier weight on the stabilizing effects of income over the potentially volatility boosting effects of a focus on capital gains.

## WHAT ABOUT THAT HIGH YIELD?

Top-of-mind, it would seem given more recent inquiries, and serving as a fine point of focus for this conversation is the relevance of the high-yield position in each of our portfolios. Represented by the SPDR Barclays Capital High Yield Bond ETF (JNK) [and the iShares iBoxx $ High Yield Corporate Bond Fund (HYG) in our Opportunity (Total Return) portfolios only], the high-yield allocation ranges from just over 13% in the Risk-Based Core Growth portfolio to 25% in the Fixed Income component of the Sector Rotation and Country Rotation portfolios and a similar level in the Risk-Based Opportunity portfolios.

We'll express the gist of the questions with a broad answer: the correlation of high-yield ETFs with various equity classes, while high at times but not always, is spurious in our view, and belies the fact that high-yield debt represents an entirely different claim on the underlying assets of the companies that carry such debt, one very much senior to that of the equity classes. And in that more senior claim, particularly in times such as these when 1) the corporate balance sheets that support such debt are, broadly speaking, more amply liquid (lots of cash out there) and 2) as a result, default rates remain at historically low levels, even though the global macroeconomic picture remains challenged (to put it lightly), while 3) interest rates are at historically low levels, thereby enabling generally larger margins of interest coverage, a sound case can be made that the high-yield fixed income class is a far more sensible way to invest in the corporate sector than equities (in this case within the U.S. Corporate sector). This is particularly true when 4) the spreads between high yield products and U.S. Treasuries remain at historically elevated levels.

## Correlated but Differentiated

Laying out that case, we'll start with the oft-cited correlation metric. Though correlation is relatively high between high yield and equities, at least in comparison to other fixed income segments, the asset classes present differing risk/reward characteristics. Normally, because the greater risk is the potential for default, which is likely to be governed by the relative abilities of the companies carrying the debt to make good on payments, we might expect high-yield investments to be sensitive to economic activity. Thus, when we experience relatively quick shifts in sentiment, we are likely to see the performance of high-yield bonds reflect that sentiment (weaker sentiment = poorer returns and vice-versa); we are likely to see the same in the equity markets. Nonetheless, we should expect the income component of high-yield returns to act as a stabilizing force. Otherwise, in relatively stable markets, we might expect the relative performance of the two assets to diverge, as the equity classes show a tendency to gyrate more heavily on the ebbs and floes of investor psyche.

A simple table will help explain what we mean. In Table 1 we show the trailing 2-year daily correlation for a selection of the ETFs we currently use, representing a wide swath of asset classes. We have colored the data to express the relative degree of correlation between the ETFs compared (we use ETFs here, as we don't want tracking error to muddy the math, while we want to reflect what's actually happening in the portfolios).

### Table 1: Asset Class Correlation Matrix

| ETF | SPY | VWO | SHY | IEF | TLT | CFT | TIP | JNK | VNQ | IAU |
|---|---|---|---|---|---|---|---|---|---|---|
| SPDR S&P 500 ETF (SPY) | 1.00 | 0.90 | -0.37 | -0.60 | -0.64 | -0.29 | -0.37 | 0.75 | 0.87 | 0.03 |
| Vanguard ETF Emerging Markets (VWO) | 0.90 | 1.00 | -0.33 | -0.55 | -0.59 | -0.26 | -0.27 | 0.76 | 0.79 | 0.14 |
| iShares Barclays Lehman 1-3 Year Treasury (SHY) | -0.37 | -0.33 | 1.00 | 0.74 | 0.55 | 0.60 | 0.56 | -0.24 | -0.31 | 0.11 |
| iShares Barclays 7-10 Year Treasury (IEF) | -0.60 | -0.55 | 0.74 | 1.00 | 0.91 | 0.76 | 0.78 | -0.44 | -0.47 | 0.13 |
| iShares Barclays 20+ Year Treasury (TLT) | -0.64 | -0.59 | 0.55 | 0.91 | 1.00 | 0.72 | 0.71 | -0.48 | -0.50 | 0.12 |
| iShares Barclays Credit (CFT) | -0.29 | -0.26 | 0.60 | 0.76 | 0.72 | 1.00 | 0.69 | -0.09 | -0.20 | 0.15 |
| iShares Barclays TIPS (TIP) | -0.37 | -0.27 | 0.56 | 0.78 | 0.71 | 0.69 | 1.00 | -0.24 | -0.26 | 0.30 |
| SPDR Barclays Capital High Yield (JNK) | 0.75 | 0.76 | -0.24 | -0.44 | -0.48 | -0.09 | -0.24 | 1.00 | 0.68 | 0.06 |
| Vanguard ETF REIT (VNQ) | 0.87 | 0.79 | -0.31 | -0.47 | -0.50 | -0.20 | -0.26 | 0.68 | 1.00 | 0.05 |
| iShares Gold Trust (IAU) | 0.03 | 0.14 | 0.11 | 0.13 | 0.12 | 0.15 | 0.30 | 0.06 | 0.05 | 1.00 |

Based on daily total return data from 11.23.2009 through 11.23.2011. SOURCE: Innealta using data from Bloomberg

Of note are the strong negative correlations between equity classes and among the Treasury classes. Also obvious is the relatively high correlation between high yield and equities. But stopping there and suggesting the latter two are one and the same exposure leaves out the critical notion that, while correlation suggests the level of directionally coordinated tendencies, it leaves out a good bit of as important or even more important details about additional relative movements. It's missing: "How far in relation?"; "How wildly swinging?"; "How much is 'guaranteed' as income, versus capital gain?"

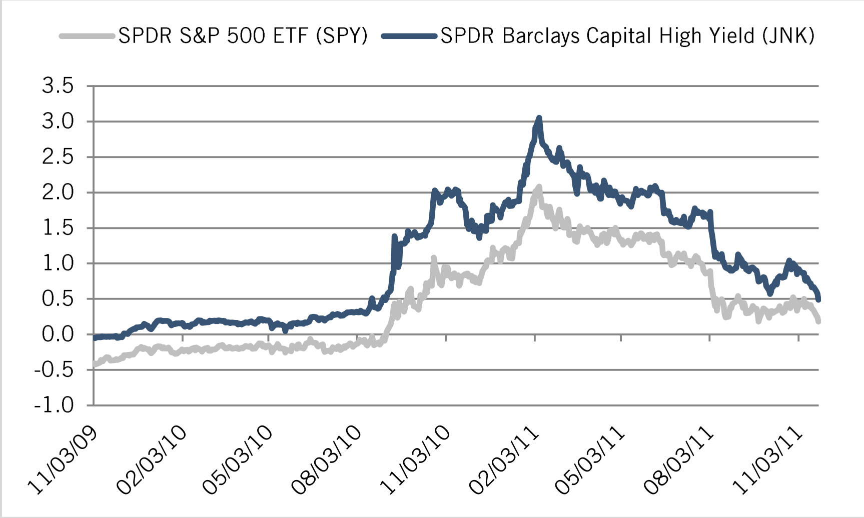
We might think that most readers can glom onto the thinking that it helps to plan a portfolio that has elements likely to often move to different extents, even in different directions, in response to particular motivations. Again, though, correlation is not the only metric to consider. Fully relevant to our portfolio construction methodology is the expected return per unit of risk that we are assuming with any given allocation. Also relevant—core, in fact, to our methodology—is the relative certitude of income over the potential for capital gain. Table 2 addresses this feature of our opportunity set. Readers should note that, not only did the performance of the high yield position exceed that of the large-cap equity slice, it did so with less volatility, leading to nearly three times the return per unit of risk. In figure 1, we detail over a longer time frame a more formal Sharpe metric (which converts absolute return into excess return relative to the risk-free rate, as proxied by the Bank of America Merrill Lynch U.S. 0-3-month Treasury Bill index, then pretty much offers the same information as the ratio of excess return per unit of risk), which shows that since the ETF's inception in late 2007, JNK has outperformed the SPY on a risk-adjusted basis over every 500-trading-day (~2-year) period.

**Table 2: Asset Class Return/Risk Metrics**

| Description | Annualized Return | Annualized StdDev | Return/ Risk |
|---|---|---|---|
| SPDR S&P 500 ETF (SPY) | 4.59% | 20.07% | 0.23 |
| Vanguard ETF Emerging Markets (VWO) | -3.59% | 27.17% | -0.13 |
| iShares Barclays Lehman 1-3 Year Treasury (SHY) | 1.50% | 1.14% | 1.31 |
| iShares Barclays 7-10 Year Treasury (IEF) | 10.46% | 7.95% | 1.32 |
| iShares Barclays 20+ Year Treasury (TLT) | 18.27% | 17.93% | 1.02 |
| iShares Barclays Credit (CFT) | 7.15% | 5.63% | 1.27 |
| iShares Barclays TIPS (TIP) | 9.00% | 6.41% | 1.40 |
| SPDR Barclays Capital High Yield (JNK) | 7.61% | 11.42% | 0.67 |
| Vanguard ETF REIT (VNQ) | 15.13% | 27.89% | 0.54 |
| iShares Gold Trust (IAU) | 20.27% | 18.66% | 1.09 |

Based on daily total return data from 11.23.2009 through 11.23.2011. SOURCE: Innealta using data from Bloomberg

**Figure 1: Trailing Sharpe Ratio—High Yield, versus Large-Cap Equity**




Data cover rolling 500-day periods, based on daily total return data from 12.05.07 through 11.23.11. Returns of the Bank of America Merrill Lynch U.S. Treasuries—Bills (0-3M) Index are used as the risk-free rate in the Sharpe calculation. SOURCE: FactSet Research Systems

Core to that return/risk spread is the marked gap in income between the two classes…that's true even today, though interest rates are at historically low levels. Over the past two years through November 23 according to Bloomberg, SPY has returned 4.59% on an annualized total return basis (assuming reinvestment of income) since November 23, 2009, versus 2.56% via simple price appreciation. Thus, a little less than 45% of the return came from the reinvestment of dividend income. Comparatively, JNK managed a 7.61% annualized total return, despite a negative price-based return; more than 100% of the total return came from the reinvestment of interest income (simple price appreciation yielded a -2.22% annualized return). Again, as reflected in Figure 1, the return from JNK was achieved with comparatively less volatility.

## ON REITS AND GOLD

Pulling the diversification thread just a bit further, Table 1 and Table 2 also support our inclusion of Gold and REITs in certain portfolios (Risk-Based Core and Risk-Based Opportunity). Similar to the high yield position, but even more so, REITs are strongly correlated with equities. They've even been a bit more volatile in recent years. However, the yield on that asset class has been of such substance that the total return has proved more than sufficient for the risk assumed. On the contrary, gold has shown little correlation with equities (a long-standing feature, generally speaking). Of course, gold offers no yield. The thinking is that it does, however, offer a more stable value over time. And, more subjectively speaking and the greater cause for inclusion in the portfolio over the past few years, gold can provide comfort in times such as these, comfort that might be expected to come in the form of capital gain.

As has been the case with high yield over the past two years, the return per unit of risk for both REITs and gold has exceeded that of large-cap equities. Referring back to Table 2, which uses ETFs as asset-class proxies, for REITs the ratio stood at 0.54 over the trailing 2-year period, whereas for gold the ratio came in at 1.09, versus 0.23 for the S&P 500.

## NEVER WITH SURETY

Lest we leave readers with the impression that such pair-wise comparisons are the norm in our analyses, we'll emphasize that the earlier exercise is meant to express the importance of diversification and income in our methodology. Indeed, the above is mostly a point-in-time analysis. In fact, any and all of the metrics so far discussed are very likely to change over time: correlations, yields, risk and total returns will shift. Even more, our approach to portfolio construction, by incorporating various forms of optimization, strives to achieve a finer diversity, a process that in our view remains more of a mathematical challenge than it is a one of guessing market directions.

## FAVORING INCOME AND STABILITY, NOT BONDS OVER EQUITY

Again, core to our methodology is an emphasis on the portfolio-level stability generally supported by income and a focus on self-relative valuation metrics. Importantly, the dynamic does not specifically favor fixed income over equity. Though the two broad asset classes require differing approaches to these analyses, their emphases are the same.

It is with this understanding that our framework operates, having been tuned to judge the evolving risk-reward dynamics of individual asset classes. In a different market environment, for example, one might be likely to experience an expansion in inflation expectations based on increased global macroeconomic growth (soon, please!). As a result, the risk/reward dynamics of the fixed income space, due to increased expectations for rising real interest rates, might be likely to pale in comparison to those of some, even all, of the equity classes, leading to 1) a shift to lower duration in the fixed income portfolio and 2) a potential increase in the fundamental and risk-relative attraction to certain equity classes, in turn leading to greater equity exposure in the portfolios.

## ON QUANTITATIVE, VERSUS QUALITATIVE

Often on these pages and in our conference calls we discuss what would seem to be more qualitative measures. We do this because it's a more credible, tangible and efficient manner to translate what we are seeing in our analytical framework into real-world events and considerations. For example, we often cite, "global macroeconomic uncertainty," as a force for risk aversion in our portfolio construction. But that uncertainty—in its effects on equity market risk as measured by volatility and momentum—is very clearly evident in our framework. Just makes more sense to talk about what we see in the framework in terms of current goings on. And we certainly are not in the midst of a grand macroeconomic revival that might otherwise have been expressed in the fundamentals. This we often discuss as well, based on our framework-level view that for most equity classes, the levels and movements in fundamentals and valuations are not sufficiently positive to warrant investment over the fixed income portfolio.

Furthermore, we have often commented on the turmoil in the political spectrum both here and abroad. If it's not already clear that political class maneuvering will affect markets—the past month's performance in particular—we'll reiterate that in particular when governments find themselves wanting to 'fix' something, policy endeavors multiply. Those efforts very often produce legislation, which comes in the form of regulation, taxation and various other forms of oversight and control. Frank-Dodd being a fine example, capital markets can be the primary focus. Alternatively, as was the case with the result of efforts at healthcare reform, a particular slice of the investment universe can be affected. It is thus very much our charge, having been entrusted with others' funds, to filter the political landscape into implications for the capital markets. Just so happens that over the past two years we've been narrating political events far more often than might have been expected in more stable markets— in our minds rightfully so and with positive net effect on portfolio performance.

## LONG-TERM VIEWPOINT

We judge the inclusion of specific asset classes into the various portfolios we manage in the context of a long-term view of return/risk potential. It is this context that allows us, across all asset classes, to look through nearer-term performance dynamics that might otherwise distract our focus. And in that context, high yield, REITs and gold all have positively contributed to portfolio performance. That is to suggest that, despite nearer-term pressures in those specific markets, portfolio performance has over the long term benefitted greatly from the incorporation of those exposures. Meantime, portfolio aggregate performance has been materially tamed via the breadth of investment among asset classes.

Our method is one that focused on the management of downside risk. And in that method is an appreciation of the stable base provided by income and diversification and the potential growth enabled through tactical allocation. See, in our view capital preservation and growth are not mutually exclusive. Via the careful selection of asset classes and the ETFs that represent them and careful construction and maintenance of portfolios, coupled with daily monitoring of relative risk and valuation among existing and potential investments, we believe that we can achieve both.

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