



Diversified Value Fund

THE ONLY GAME IN TOWN

You may well ask: “Why, in the face of turmoil in the Middle East, soaring oil prices, disaster in Japan, a continued worsening of the European debt crisis and looming shutdown of the U.S. government; the stock market had its best first quarter in 11 years?”

True, all that gain came in the last two weeks of the quarter, and it was confined to a few industry groups, but a rally is a rally and the question is still: Why?

The answer probably isn't that investors wanted to buy stocks near their highs for the last three years. The answer probably is they had no choice, because stocks are the only game in town right now. The fact is that there is a lot of money around. The Treasury is printing it, investors have saved it instead of spending it and it's coming out of real estate and bonds. It's got to go somewhere, and stocks have very little competition.

Cash yields nothing and bonds yield next to nothing and look risky in the face of rising interest rates. Real estate just burned everybody and is unlikely to be the investment of choice again anytime soon. Gold looks topy and emerging markets are expensive and dicey. Europe's economy is being pulled down by its weakest members and its strongest counties continue to be in a state of denial.

That leaves good old U.S. equities as the investment of choice, or at least the choice by default. That's fortunate because for once investors are being forced to do what is probably the right thing, buy equities. Historically equities have performed best when the economy is growing slowly, inflation is increasing gradually, interest rates are increasing moderately and investor sentiment is going from dire to optimistic. In other words, what the world is likely to look like for the next few years.

With that gradual growth there will be periods when the economy retrenches. There will be spikes in commodity prices, thanks to the speculation of overactive traders. Economic growth is often accompanied by political change, and it's pretty clear that natural and man made disasters have been, and probably always will be part of life. All these things keep investors nervous but they keep the stock market from getting overheated and make the rally last longer.

I believe there are opportunities in every sector of the equity market, but I am particularly excited about the prospects for large companies with strong balance sheets and international businesses. While these companies have typically traded at a premium to their more risky, less well capitalized peers, today they trade at a discount, even when you adjust for expected growth rates. **Life is good when you can buy a portfolio of world class companies at very reasonable price in an improving economy!**

ASSET ALLOCATION

How much more money should you put into stocks after my glowing outlook for the market? The answer is not a penny! You should have an asset allocation that doesn't change regardless of my opinion, the gyrations of the economy or the state of the world.

The most important investment decision you make is to determine your asset allocation. For most people, this will be a balance of investments between cash, bonds and stocks. Studies have shown that 80% of your investment return will be determined by this decision. More importantly, it will be the decision that will either let you sleep at night or wake up in a cold sweat. How do you do it?

LEAVE IT TO A MARKET TIMER

An attractive alternative to you making the asset allocation decision yourself is to leave it to a professional to make it for you, based on which market they think will perform best.

In my last newsletter I described these market timing gurus as “charlatans, cowards and fools”. Following their advice will involve a lot of expensive trading. You'll be hit with commissions plus capital gain taxes and it will be confusing. The experts are always conflicted. There is no reason to believe that anyone can successfully time markets but most importantly, the decision is too important to leave to anyone else.

As we will see, asset allocation is a very personal decision that only the investor should make. Only you know what your income requirements are, how much risk you feel comfortable with and how you feel about various investments.

I believe that an asset allocation is something that should be determined by an investor's needs, not the whims of the market or the opinion of an advisor. It should change only when the investor's needs change, not because we think we can predict the future.

USE A SET FORMULA

One of the most popular formulas to determine your asset allocation is take your age and subtract it from 100 to get your allocation to stocks. If you are 30 you want 70% stocks. At age 70, you should have just 30% stocks. It makes some sense. When you are younger you can afford to take a fair amount of risk, but as you get older you need the income and safety bonds offer.

It's a start, but your individual situation may vary greatly from that formula. If you are twenty-five and are saving up to buy your first house so you can start a family in a few years I'd ignore the formula. You don't want to put off owning a home just because the market happens to have one of its regular corrections.

If you are lucky enough to live to be ninety-nine with plenty of money and your estate is going to grandkids aged 25-45, your asset allocation should be based on the needs of your heirs, not yours. It would be totally appropriate to have an all equity portfolio, despite what the formula says.

COMPUTE A TARGETED RATE OF RETURN

Most financial planning programs use something called a Targeted Rate of Return, which dictates your asset allocation. You inventory your assets and liabilities, estimate your expenses and inflation; the computer blinks and the program will tell you the rate of return you will need to get the income you want. If the answer is 2%, you don't have a problem. You can get that with any asset allocation, but does that mean you should put all your money short term treasuries? Or does it mean you can afford to take risk and you can live off dividends from an all stock portfolio?

Alternately, if the answer is 8%, what do you do when bonds only pay 2-3%? Sure, an all stock portfolio has a 100yr average return of 10%, but if put all your money in stocks ten years ago and took out 8% a year you'd be almost broke now. You can take that risk, or you can guarantee that you'll outlive your money by putting everything in bonds. Unfortunately this is your choice. The target rate doesn't solve the problem for you.

IT HAS TO BE YOUR DECISION

Only you know what will let you sleep at night. Only you can make the decision between current need for income and long term security. Only you know what you'd be willing to give up if things go badly and how important it is to see your money grow.

ASSUMPTIONS

To make an educated asset allocation decision we have to make some assumptions. Here are the assumptions I make. If yours are different, work with that.

Returns: Long Term (10 years or more) stocks will outperform bonds and bonds will outperform cash, which will have a negative (after inflation) return. The fact that bonds outperformed stocks during the 1998-2008 time frame is just the exception that proves the rule. It has happened less than 2% of the time for the past century. You have to make a decision based on what happened 98% of the time not 2%.

Risk: Stocks provide a better long term rate of return because they are at least twice as risky as bonds and cash is riskless. Unfortunately, you are almost guaranteed to lose money after inflation in cash and other short term investments.

Time is the antidote for risk for both stocks and bonds. The longer the time horizon the less risk an investor takes. The stock market has never had a negative twenty year return.

Income vs Capital Gains: I don't care how I get my required income or how my money grows. It doesn't matter whether it comes from interest, dividends or capital gains. All I care about is that I started five years ago with X, I got income of Y after taxes and I now have Z. If Z is bigger than X, I'm happy. That lets me avoid the trap of having to put money in high yielding securities when I could make more money with growth.

There are a few other things you need to know to determine your asset allocation. One is your income requirement (or savings rate if you are still working). The second is your age and the age of your dependents or heirs. Third is your minimum desired asset level or risk tolerance.

Investors are constantly asked to describe their risk tolerance. 90% of the time the answer is low to moderate but what does that mean? Is that a well diversified blue chip stock portfolio or a 50/50 stock bond allocation?

One way to approach the problem of determining risk tolerance is by asking: “How much money must I have, no matter what?”

THE STRESS TEST EXAMPLE

Let's say the answer is \$1 million. You cannot live without that amount of wealth. OK, let's stress test your current asset allocation.

Your house is worth \$1 million, but the real estate market might go down further and you might have to put some money in it to sell it. There are closing costs and maybe taxes to pay, let's say in the worst case, the house is worth 50% of today's value or \$500,000.

You keep \$50,000 in cash and short term investments. Value that at 100%, \$50,000.

You have \$300,000 in good quality, short to intermediate term bonds, but in a worst case scenario they could get a haircut from rising interest rates or another financial panic. So, value them at 80%, \$240,000.

You have a \$700,000 stock portfolio of mostly well diversified, blue chip stocks. So, let's say the worst case would be that the market goes down 50% for awhile. Sure it will probably come back after that, but if you're not worth \$1 million you might not. Stocks stress test down to \$350,000.

Add it all up and you should never be worth much less than \$1,140,000. Alternately, you might be down \$910,000 for awhile, but if one million is the magic number you're golden, and 70/30 is the perfect asset allocation for your risk tolerance. It will let you sleep at night and most importantly, you should be able to weather just about any storm, as long as you don't need too much income.

INCOME STRESS TEST

How much income is too much? Let's say you're getting \$50,000 a year from SS and pensions, and need another \$80,000 pretax to keep your current standard of living. \$80,000 is 8% of your \$1 million investment portfolio but you only get about \$9,000 (3%) from your short term bond portfolio, \$18,000 in dividends (2.6%) from your stock portfolio and 1% on cash and short term investments.

YOU ARE SPENDING \$80,000 AND TAKING IN \$27,500. HELLO POOR HOUSE!

Not likely! Yes you are spending \$53,000 more than you are taking in, but first of all, if you think stocks only will give you 2.6% over time you should own bonds instead. So we have to make some assumptions about the growth of our stock portfolio beyond dividends.

Estimating the long term returns on investments could easily take-up a whole newsletter, but for this example we'll use the dividend yield of 2.6% plus 3.4% capital gains for a total return of 6% on equities. That's well below the near 10% return stocks have provided for the past century, but

5% better than inflation and about twice what bonds are yielding. When inflation comes back we can revise those numbers, but we need to deal with what's happening now.

Using a very conservative 6% total return on stocks, we are expecting a total return of \$51,000 for an expected negative annual growth of \$29,000 a year versus our income requirement of \$80,000. Still bad, but it's manageable. At that rate it would take over fifteen years to spend down a million of our two million dollar net worth and even if we have the worst case disaster we allowed for earlier, and it took five years for the market to recover, you could survive. You might have to sell the house to put that equity to work, but you'll make it.

If you want to do the math to make sure you won't outlive your income, this is where financial planning software becomes very useful. It will do something called a Monte Carlo Analysis. No, it doesn't figure out the chances of breaking the bank at a Mediterranean casino. It computes your chances of outliving your money ASSUMING your income requirements, future rate of return, inflation and market volatility. Those are a lot of assumptions, but getting the answer is probably better than not knowing anything. Most importantly, if it helps you sleep at night, it's well worth the effort.

In this example a 70-30 allocation works for now. We stress tested the portfolio and think you can survive. It gives you enough income and capital appreciation to meet your income needs and you can sleep at night. Great!

THE BARBELL ALLOCATION

I have some clients who retired, lived well and provided for their heirs without ever owning a bond. They just had cash (money markets, T-bills) and stocks. Their rationale was that stocks will outperform bonds over any reasonable amount of time, so why own bonds? If your time horizon is intergenerational and you can live on the dividends stocks provide, it's hard to argue with that logic.

Unfortunately, for most people 2-3% dividend yields might not be enough income. They will be forced to sell stocks to supplement their income, and selling stocks when they are down is never a good idea. For those people there is the barbell approach to asset allocation. The barbell approach consists of just cash and stocks, the two ends of the risk bar, and ignores bonds, that typically take up the middle. Using the above example, what if we add \$100m to cash we'll have \$150m. That allows us to put \$900m instead of \$700m in stocks.

Lets stress test the portfolio:

Stocks: $\$900,000 \times 50\% = \$450,000$

House $\$1,000,000 \times 50\% = \$500,000$

Cash $\$200,000$

Total: $\$1,150,000$. That is about the same as the 70/30 allocation!

How about total return?

$\$900,000 \text{ stocks} \times 6\% = \$54,000$

$\text{Cash } \$200,000 \times 1\% = \$2,000$

Total: $\$56,000$ vs $\$51,500$ for the 70/30 balanced portfolio. $\$4,500$ a year better!

KEEP IT SIMPLE AND ASSUME THE WORST

For me the keys to a good asset allocation are that it is understandable and sustainable. Understandable to me means simple. If I can't reduce my financial picture to a single sheet of paper, preferably the back of an envelope, I can't really understand it. If I don't understand it, I can't have confidence in it. You can go into all the detail you want to in coming up with the numbers but in the end, you need to be able to see the big picture.

If the market crash of 2008 caused you to modify your asset allocation, it was a bad one to begin with. You neglected to assume the worst.

Failure to account for market volatility in your asset allocation decision would be like assuming you are going to drive from NY to LA without stopping for gas. It's just part of the trip. It's unlikely that you will see another correction (PANIC!) like we had in 2008 again in your lifetime, but if you plan on it, you won't be disappointed.

If you went to 2008 assuming that at any time you could be subject to a 50% correction that lasted four years, you were pleasantly surprised to see ONLY a 40% correction and that you got most of your money back in two years. You didn't have to change a thing, other than doing some rebalancing. You had planned on a disaster happening at regular intervals and sure enough it did.

Westport Resources has all the tools and expertise you need to assist you in making your asset allocation decision. Please let us help you, but keep in mind that it's a decision only you can make.

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