Built to Last

Although their strategies vary, Rob Arnott and his peers—and yours—are hewing to a long-term focus on fundamentals, valuations, costs, and taxes

BY KATHLEEN M. MCBRIDE

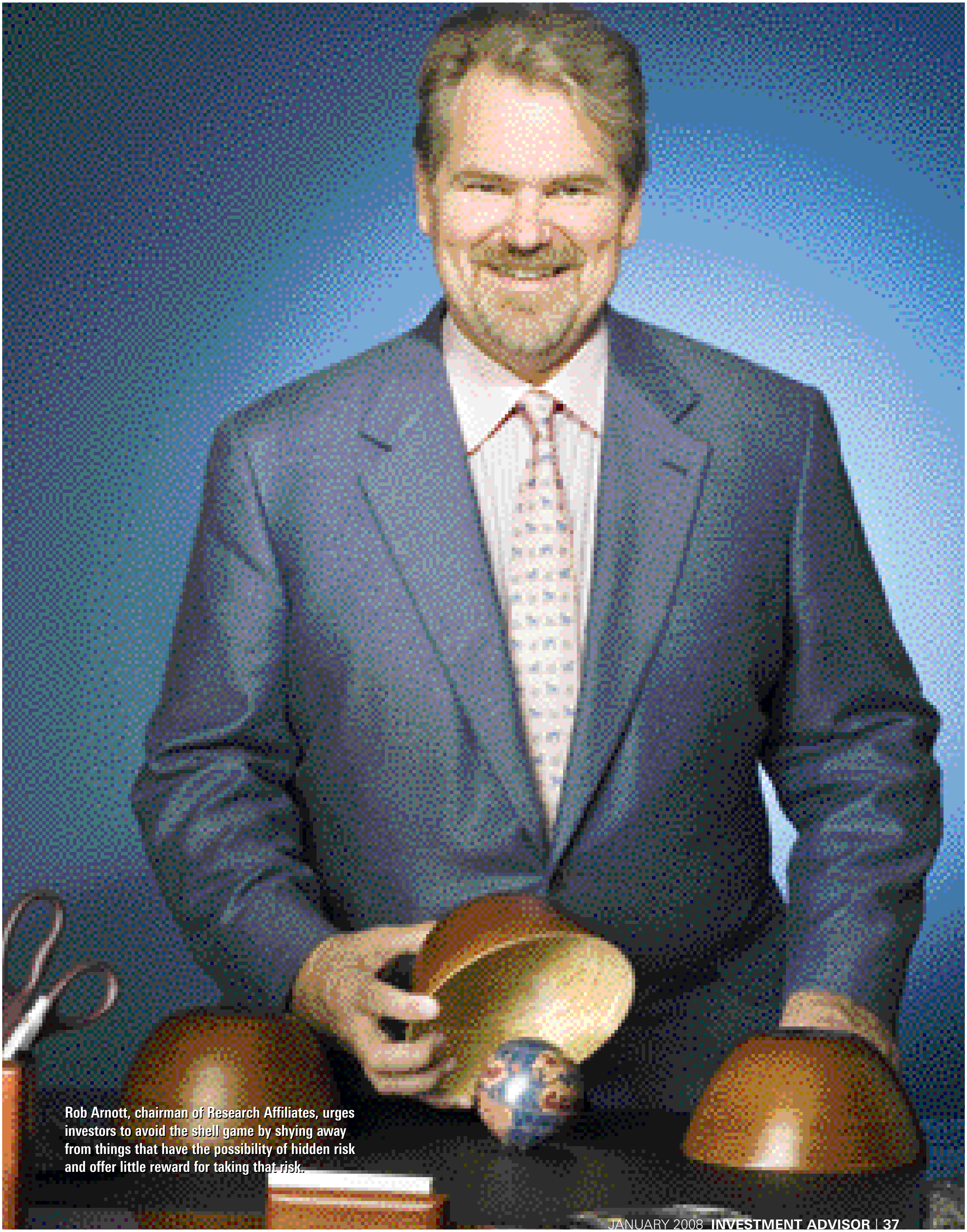
BUILDING PORTFOLIOS IN times of tumult can be very challenging, even for the most seasoned of advisors. Given what's currently unfolding in the credit markets and economy, and higher volatility in the equity markets, should advisors change what they are doing as they build clients' portfolios now? One advantage for those who are veterans of advising clients is the experience that comes with participating in economic and market events as they unfold, and noting the effects of their strategies on investment portfolios. That kind of context can be invaluable now, as many uncertainties remain in the mortgage, credit, and currency markets, and the financial sector as a whole, and as clients still demand—and in many cases need, as never before—consistently good performance from their portfolios.

How fortunate then that a cadre of advisors is willing to candidly share their views on building portfolios now, wisdom other advisors may adapt for their own clients, advice that will undoubtedly prove important as advisors move with clients through these stormy seas and, if the consensus is correct, the lower returns that may lie ahead.

TAKING THE VERY LONG VIEW

Rob Arnott is a man who seeks investing wisdom by looking back, not months, or years, but centuries, using scads of historical data to give context to current markets and forge a tempered long-term outlook. "Invest where you can get a premium yield without necessarily being involved in the assets that are afflicted by subprime contagion," advises Arnott, who is chairman of Pasadena, California-based Research Affiliates, the asset management firm he founded

Photography: Steve LaBadessa



Rob Arnott, chairman of Research Affiliates, urges investors to avoid the shell game by shying away from things that have the possibility of hidden risk and offer little reward for taking that risk.

in 2002. His firm developed the Research Affiliates Fundamental Indexes (RAFI), which use company fundamentals—sales, cash flow, book value, and dividends—to weight indexes, instead of using market capitalization. "In general, what you want to do as an investor," according to Arnott, "is invest where people are afraid, invest where the risks are obvious and are probably already in the price, and shy away from things that have some possibility of hidden risks and where you aren't getting much in the way of incremental reward for your risk. That's one of the things I found fascinating about subprime—people went to it because of a surprisingly skinny yield premium, even though they had never been tested in a recession."

One place Arnott is finding premium yield is emerging markets debt. "We find local-currency, emerging-markets debt to be awfully interesting. You get a premium yield and you get the added kicker of a decent likelihood of currency appreciation…that can turn a relatively high-yield asset into something that has really quite an attractive total return." One change he made this fall was that "by September 30 we had ramped up our exposure to local-currency emerging-markets debt, both short-term and intermediate maturity, not so much on the long side, partly because there's not much of it, [and] partly because of concerns about the risk of rising rates." Arnott's a fan of emerging-markets debt because "in many of these markets you get 2% to 3% premium yield, and you get the possibility of currency appreciation instead of depreciation. Credit quality is pretty good; the notion of subprime contagion spreading to emerging markets makes no sense at all—they're totally different economies…the health of their economies is frequently linked to commodities; commodities have done fine."

As far as the equity portion of portfolios, Arnott advocates "modest to moderate allocations to equities," tilting toward value, large cap, and quality, "because that's what does well when the markets are expensive." Advisors who use indexes to capture beta might want to consider whether cap-weighted indexes—the more expensive the stock, the higher the cap weighting in a cap-weighted index—are the way to go, or if exposure to the market via fundamentals-based indexes might be in order. "Of course, I'm a big fan of fundamental indexing because that's what we invented, but if you have to have stocks—and most investors do—it makes sense to make sure that there are earnings, and sales, and dividends, and book value standing behind that investment, so that the valuation multiples aren't out of sight, so that you aren't buying a hope and a prayer of future growth." But, cautions Arnott, don't go blindly into growth just because value has done well over the past several years. "Value is a useful foundation. Looking for growth is good, but paying vast sums for growth that has not yet materialized is dangerous, especially if we roll over into a bear market," which, in Arnott's opinion is, "more likely than not."

MOVING TOWARD GROWTH

Not everyone believes value stocks are the place to be right now, though. Traditionally a "big believer in U.S. equities," Lincoln Anderson argues that "the underlying fundamentals are very good, and I think we've got record—or near record—high pre-tax earnings, near record-high tax payments, near record-high after-tax earnings, record high dividends, and then companies are buying back huge amounts of stock." Anderson, chief invest-

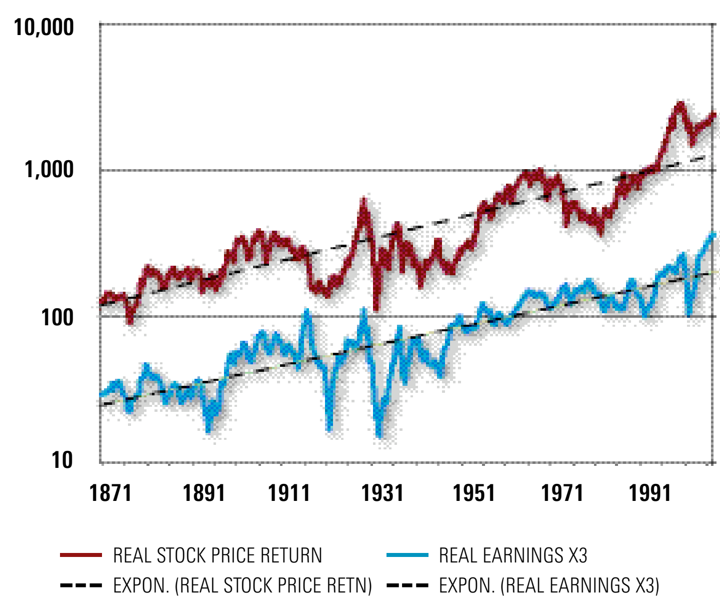
Not different this time?

HERE'S HOW ROB Arnott addresses that oft-heard refrain about the markets:

"I'm not afraid of volatility. Volatility doesn't scare me in the least—I'm afraid of volatility if you're not getting paid for it, and that's the reality now. If stocks are priced to give a decent yield to compensate for the volatility, I'm fine with that. I'm not eager to expose myself or my clients to an asset class that is expensive by historical standards, that has earnings 60% above the 10-year average, and [is] facing some real risk that in a recession they could retrace a lot of their growth. Where stocks are 60% above their 10-year average in terms of price—that creates a whole set of risks that are pretty uncomfortable—basically the markets are saying, 'Things are different this time,' and all too often, when the markets say, 'Things are different this time,' they're wrong."

REVERSION, NOT RANDOM

DO PRICES AND EARNINGS REVERT TO THE MEAN? ABSOLUTELY.
DO THEY FOLLOW INDEPENDENT RANDOM WALKS? NO.



ment officer of Linsco/Private Ledger (LPL) in Boston, says he advocates "a big tilt towards growth and away from value," citing a "huge performance run over the last five-and-a-half years on the value side of the stock market. I think it's riskier than investors perceive, and I think over on the growth side there's much less risk, so I think, paradoxically, the risk-return characteristics on the growth side of the market are much better than on the value side."

As much as he believes in U.S. equities, though, Anderson is moving "away from international." Typically, he recommends an allocation of "somewhere in the 15% to 20% range, and that's a high allocation in my opinion because for LPL clients, at least, this is retirement money." But, "when it's retirement money, all of the future liabilities are going to be dollar-denominated; its not like many people are planning on living in Spain in retirement, so when you have the dollar exchange-rate down at the all-time record low here, to have heavy international investments now is quite risky. We've cut back our percentage—we're down to 10% or under for international assets. "I just think it's very risky…people are advocating 50% exposure; now is not the time for that." Anderson adds that with large-cap exposure such as the S&P 500 Index, "50% of sales are overseas, so you get a lot of indirect international exposure that way, and exchange rate exposure."

FOR IBBOTSON, STOCKS WILL DO

Though he agrees with Anderson on a migration toward growth because of the long run of value, Roger Ibbotson likes the idea of a "rather diversified portfolio from a global perspective," including debt and equities. "I might advocate up to 50% because of the fact that 50% of the global market is foreign, but we can't realistically go that far." Ibbotson is the founder of Ibbotson Associates, which he sold to Morningstar in 2006; a professor at Yale University's School of Management; and chairman of Zebra Capital, a hedge fund based in Milford, Connecticut.

"In the long run, in general, my favorite asset class is stocks," he declares. Small cap, and value, "had a wonderful run from 2000 through part of this year, but that run seems to be over; I don't think [they] are particularly attractively priced right now," so he suggests migrating toward mid- and large-cap stocks. "The thing that's potentially looming here is a recession, people put [odds on that] at 30% or something—if we actually do have the recession it would not be good for the stock market."

Regarding the mortgage-backed vortex, "the thing that does get hurt is the dollar," notes Ibbotson. It was "pretty predictable that they would weaken the dollar, but a weaker dollar doesn't hurt U.S. corporations. To the extent that they're exporters, it's easier to export when the material prices they might get here in the United States are now lower, and they can export, effectively, at lower prices." For the fixed-income portion of clients' portfolios, "we've definitely migrated away from lower-credit bonds, and from REITs to some extent," adding that "higher credit bonds are doing very well," though shorter durations may be called for now. "Foreign debt, particularly in foreign currencies, and gold can be attractive in an environment with a falling dollar," Ibbotson explains, concurring with Arnott on that.

Fundamental Indexing Defined

FUNDAMENTAL INDEXES, LIKE the ones created by Rob Arnott, chairman of Reseach Affiliates, are based on companies' fundamental data, such as sales, book value, cash flow, dividends, and number of employees, while a company's market cap is ignored. One way to look at fundamental indexing is as a bridge between passive and active investing. The fundamental metrics can be blended or used singly in the indexes. A variety of mutual funds and ETFs are based on fundamental indexes from Research Affiliates and Wisdom Tree.

Cap-weighted indexes are based on companies' market capital. When companies in cap-weighted indexes are over-valued, they carry a heavier weighting in a cap-weighted index, leading to what Arnott calls a drag on return. The S&P 500, which celebrated its 50th anniversary in 2007, is the most prominent cap-weighted index.

For more of the thinking behind fundamental indexing, go to: **www.researchaffiliates.com**, **www.wisdomtree.com**, and **www.investmentadvisor.com**.

LONG TERM: HOLY GRAIL OF COSTS AND TAXES

When clients ask Harold Evensky, president of Evensky & Katz Wealth Management in Coral Gables, Florida, what to do now, he tells them to look 10 years out because over time the world economy and domestic markets will be up. Allocate assets, "not by looking backwards; [but] by looking forward…over the next economic cycle," he advises. Evensky's figuring on real returns, over inflation, of 6% for equities, and 2.5% for fixed income. "As a consequence of that, we think it's far more important than it was maybe 10 years ago to focus on the management of taxes and expenses, because when returns go down, expenses don't go down."

Advisors who agree that returns will "be lower need to rethink how they design portfolios," Evensky asserts. "Most portfolios have way too many moving parts—there's too much tax and expense drag in traditional portfolio designs if you believe that it's a low-return environment." With that in mind, Evensky & Katz totally revamped how they structure portfolios "quite a few years ago," he notes. They were "multi-asset class, multi-style," using a lot of different managers; now portfolios are structured as "core and satellite," with a mix of passive and active management. Currently at 80% of the equity portfolio, the core is intended to "simply capture the market return as cost- and tax-efficiently as we possibly can." Like all virtuosos, Evensky makes it look easy: "It could be something as simple as putting all [of that portion] into the S&P 500. Our major investment is the Barclay iShares Russell 3000. In general that's close to 50% of our equity allocation. Because we believe in the Fama-French research, and we believe in the value-, and the small-cap factors, we overweight that," typically using Dimensional Fund Advisors (DFA) funds. "That's probably 60% of our allocation that's passive. The international—because we think that's roughly half the world's financials, is the fourth component of our core allocation," using "Julius Baer, an active manager, and DFA, a passive manager."

LOOKING AHEAD

INVESTMENT ADVISOR'S MARKET STRATEGISTS' PREDICTIONS FOR WHERE THE MARKETS AND ECONOMY WILL BE AS OF DECEMBER 2008

	DJIA	S&P 500	Nasdaq	Fed Funds	10-Yr Treasury	GDP*	CPI*	$/Euro	Stk/Bd/Cash
Richard Bernstein, Merrill Lynch	—	—	—	2.50%	3.70%	2.00%	2.40%	—	—
Gary Shilling, A. Gary Shilling & Co.	12,000	1350	2200	4.25%	3.75%	-3.80%	-0.60%	1.40	10/80/10
Gail Dudack, Dudack Research Grp.	14,575	—	—	4.00%	4.75%	2.50%	2.30%	1.40	70/15/15
Sam Stovall, Standard & Poor's	14,945	1650	3130	4.00%	4.75%	2.90%	2.50%	1.50	60/20/20
Stuart Schweitzer, JPMorgan	15,000	1650	3000	3.50%	4.00%	2.00%	2.00%	1.40	60/30/10
Lincoln Anderson, LPL Financial	15,500	1725	3250	4.00%	4.50%	3.50%	1.00%	1.35	80/15/5
Mark Keller, A.G. Edwards & Sons	13,800	1475	2600	3.00%	4.50%	3.50%	2.00%	1.37	65/30/5
Mark Balasa, The Alpha Group	14,900	—	—	5.00%	4.20%	3.70%	2.70%	1.42	62/27/1
Median	14,900	1650	3000	4.00%	4.35%	2.70%	2.15%	1.40	60/27/10
Averages	14,389	1570	2836	3.78%	4.27%	2.04%	1.79%	1.41	57/31/9
Actual 12/10/07	**13,474**	**2671**	**1486**	**4.50%**	**4.10%**	**4.90%**	**3.50%**	**1.47**	

*Third quarter 2007 actual

(For more on our panel of market strategists and their asset allocation suggestions see page 26)

The satellite portion of the equity portfolio is where Evensky gets tactical. "Our core is the strategic allocation," Evensky explains. It rarely changes, it's long term, and we expect to be in it over economic cycles. In the satellite our economic horizon is around 12 months. We'll invest in something and if it does extraordinarily well, better than we ever expected, then we may get out of it and go back into it again later." That's where they'd put exotic or alternative investments. "We've got some 120/20; the PIMCO Developing Local Markets, which is basically an emerging markets money market; we've had commodities." Advisors might be surprised to see one allocation in the satellite that is based on reversion to the mean: "even though we have a long-term, strategic bias-belief in small and value as factors, we've got a small allocation to large-cap growth in the satellite, because we went through a period in which value and small did extraordinarily well, and we were basically investing back on the belief that there would be a regression back from an overreaction to that." For efficient large-cap growth exposure in the satellite, Evensky likes "the Russell 1000 Growth iShare."

Capital preservation is the goal for the fixed-income portion of Evensky's client portfolios, and he ladders bond maturities, usually looking for "A or better quality and a five-year duration." He notes, however, that "for quite a few years we've been closer to probably AA in quality and about a 3.5 year duration" but again has started extending duration out toward the five-year area. Evensky "loves TIPS, but they're so damn tax-inefficient that we only do that in sheltered accounts." To smooth volatility, he includes a global fixed-income bond allocation, again with Julius Baer, but for most of the fixed-income portfolios, "if it's a taxable portfolio, it's in munis; if it's sheltered [from taxes, as a retirement account would be], then it's in high-quality corporates." If a client's fixed-income portfolio is under $1 million, Evensky will use short and intermediate bond funds; for more than $1 million, he works "with individual managers, we're not using platforms or separate accounts. We've sort of bypassed all the middlemen and simply negotiate directly with the money managers," something that gives him more control and keeps client costs down.

VALUE, SAFETY, TIMING

Gene Balliett made a big change in how he invests for clients about a year ago, as he became disenchanted with many of the no-load mutual funds his firm had used in clients' portfolios. The "majority" of funds "hide their cards" with window dressing before they "reveal holdings," according to Balliett, and he's aghast about funds' 12b-1 fees, although he uses a handful of no-load funds for diversification in accounts that have less than $50,000 to invest. Balliett Financial Services, fee-only advisors based in Winter Park, Florida, began using a black box model developed with Gene's son, Phil, "an absolute whiz with the computer, and long a student of both value and quant investing." The Ballietts did extensive back-testing using nine years of data. After years of research, they found a group of five screens that they use in their model, which gives them a starting point for stock selection. "This marks a major departure for us," according to Balliett. Each day the model sums up buy and sell recommendations for stocks, which then get a human touch from a member of the five-member investment team who is charged with looking "for an excuse not to invest in [a stock]; if he doesn't find any, we'll buy it." In a nutshell, their approach, as Balliett puts it, is "value, safety, and timing." It's a fundamental value approach, with a lot of latitude in market cap, sticking with a cap of "$500 million or higher," he says. "I really like GARP—I like value stocks that are breaking out."

Staying focused on the stocks on his firm's watch list, Balliett doesn't get distracted by the short-term gyrations of the credit markets and economy, or whether growth or value, or a particular cap weighting, is in favor. That said, his clients' portfolios

ON THE MONEY

THE IA ASSET ALLOCATION PANELISTS WHO CAME CLOSEST TO THE MARK IN PREDICTING ACTUAL YEAR-END 2007 NUMBERS

Panelist		Prediction*	Actual**
Anderson	DJIA	13,500	13,474
Dudack	S&P	1600	2671
Shilling	Nasdaq	1950	1486
Stovall	Fed Funds	4.50%	4.50%
Bernstein	10-Yr Treasury	4.25%	4.10%
Balasa	GDP	3.00%	4.90%
Balasa	CPI	3.50%	3.50%
Schweitzer	Yen	112	112
Keller	Euro	1.35	1.47

*Made week of 11/20/2006 ** As of 12/10/2006

are basically out of the financial sector for the moment: "I don't think we own any now," although, "I hope our system identifies the financial sector, and specifically the stocks that have turned around, very early after they've turned around, because they're going to be a hell of a buy at some point." One sector that Balliett is very excited about now is "sun power. Solar energy has more potential for a quick breakthrough than wind or wave, or even geothermal—I'm for all those too; in time they will all be going gangbusters—but the first one out of the box is going to be solar," he asserts, citing breakthroughs such as a new kind of paint that gathers solar energy—"imagine cars or buildings painted with it."

BROADER DIVERSIFICATION

"The credit issue has been a focus for the second half of the year and had tremendous impact on the markets, and I think we're still going through that," notes Peng Chen, PhD, president and chief investment officer of Ibbotson Associates, in Chicago. But investors really need to take a long-term view rather than a short term, tactical view, he says. "Diversification is very important; you always want to have a well-balanced portfolio and maintain that discipline over time unless there's significant change over the longer period that has a impact." Locally geographic diversification, however, across a region such as European countries or North American countries, according to Chen, has become more closely correlated, so portfolios need to broaden geographic diversification. "Don't get me wrong, there are definitely still diversification benefits, but they're not to the same extent," as correlations are closer across local regions. However, Chen argues, "you should still diversify and actually it's much easier to do that today—to get a broad diversification" geographically.

Another area for advisors to focus on in structuring portfolios is "a big change in demographics, a lot of people are coming to retirement. Now, retirement spending and retirement funding are going to become more and more important when you're trying to manage the portfolio" for a client. The "liability stream" necessary in retirement "is tied to some sort of inflation adjustment, so the asset classes that tend to provide an inflation hedge tend to be more attractive for a retirement portfolio," including, "for example, inflation indexed bonds" such as TIPS, "or commodities or real estate."

Another asset class for retirement portfolios is "annuity products that either guarantee an income or guarantee a withdrawal rate for as long as the investor lives, and it depends on the specific investor but that could be particularly attractive for investors, because it guarantees a particular outcome," Chen notes, and also "takes care of the volatility environment and the longevity environment." This strategy, meant for just a portion of a portfolio, can be divided among some number of issuing companies to diversify default risk. Product cost is a factor here, but "with a reasonable-cost product, these type of outcome-based products could make sense."

As far as sectors go, LPL's Anderson says too much is still unknown about what the real mortgage and credit issues are for financial companies, "so we're not recommending bottom fishing on the financials here." Energy and commodities-related sectors concern him as well, so he suggests moving a little bit away from financials, oil, and commodities, and adding a bit in "areas like technology, and healthcare," because with more baby boomers approaching "age 65 as a percent of the total population," he declares, those sectors are "really going to start to take off, so you've got the wind at your back."

In the financial services sector—and nearly everyone had a nervous chuckle when asked about this sector—Arnott says, "Fundamental Index has a very similar market weight on financials as cap weighting, about 1% to 2% higher, so it's not materially different. That said, I think we've seen the first-third of the damage of subprime contagion; two-thirds lies ahead. If two-thirds lies ahead, then financial services are likely to struggle in '08. My personal view, and this isn't reflected in Fundamental Index—because it's an index—is that financial services are going to continue struggling in '08, they'll continue to disappoint. But at some stage they become a buy. I think the time to view them as a buy is when folks are just terrified of them—they're not there. People looked at the $7.5 billion [stake] from Abu Dhabi into Citigroup as wonderful news—I'm more inclined to view it as a cry of desperation that they would even need that."

The important thing, these experts indicate, is that whether an advisor feels that clients' portfolios should tilt toward equity or fixed income, domestic or international, value or growth, the ability to maintain long-term strategic focus and make tactical shorter-term shifts, when necessary, goes hand in hand with keeping a eye on costs and taxes. That seems to be what's necessary for pulling together portfolios that are positioned for a possibly lower return environment ahead. **IA**

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