

Thought for the Week: Monday, May 31st, 2010

DIAS Portfolio Positioning

The VIX, the Chicago Board Options Exchange Volatility Index, is often an excellent measure and predictor of S&P500 price volatility. **The Fear Index, as it is sometimes called, represents the market's expectation of volatility** over the next 30 day period. It is calculated from the prices of Options.



Following an extended period of falling market volatility, May 2010 saw it spike. Although the jump was nowhere near the level of 2008, it was clearly more severe than recent corrections. As this puts a scale on the ups and downs we have just experienced, let's use this week to **review our current thoughts on DIAS Portfolios**.

DIAS comprises Four CORE Portfolios and Three EXPLORE Portfolios. Each CORE portfolio is designed to meet specified investment and risk tolerance requirements. They are defined by their Risk, Return and Income Potential and are maintained for long-term investment purposes. **The EXPLORE portfolios** are designed to address specific investment Opportunities or Concerns and may vary according to prevailing market conditions.

When compared with 'Traditional' investment portfolios, investors should expect to see **more Diversification and Active Management** within a DIAS portfolio. Our goal is to actively spread the susceptibility of portfolios to sudden and dramatic declines and react to opportunities. If we can't do this for every price drop, we will analyze the situation and look for areas where we can recover quickly.

A good portfolio is more than a long list of good stocks and bonds. It is a balanced whole, providing the investor with protections and opportunities with respect to a wide range of contingencies. Professor Harry M. Markowitz Portfolio Selection, 1959

CORE Portfolio 1: Conservative Income Portfolio (CIP)

Many studies suggest that an investment with approximately 80% allocated to Fixed Income (Bonds) and 20% to Equities, or similar investments, is an optimal diversification over the long-term for a conservative investor. However, CIP investors have an aversion to Equities therefore the Equity allocation of this portfolio is generally lower than the traditional 20% and the Bond component may be higher than 80%.

Over the last six to nine months, this portfolio has sought to **reduce its exposure to rising interest rates** as a way of protecting capital in preparation for the higher inflation and interest rates. We believe higher interest rates will result from monetary easing in the extremely low current interest rate environment.

The active nature of DIAS portfolio allocation **currently has approximately 75% in Bonds, 10% in Equities and 15% in other investments such as Commodities and Master Limited Partnerships.**

How have we **diversified the portfolio away from ‘traditional’ interest rate sensitive Bonds?**

- Senior Loans, Floating Rate Loans (which will increase yield with interest rates) and Preferred Stock.

How have we **reduced the portfolio’s sensitivity to interest rates?**

- Reduced the average duration of the Bond exposure. Duration is the approximate amount the value of a bond will change for one percent change in interest rates.

This strategy of protecting against interest rate rises worked well for a considerable period; however, recently renewed European-based turmoil and government intervention have kept interest rates lower for longer than we expected.

We are currently lengthening our estimates of when interest rates will rise and adjusting the portfolio accordingly.

CORE Portfolio 2: Conservative Income with Growth Portfolio (CIWGP)

The CIWGP is similar to the Conservative Income Portfolio but without the aversion to Equities, taking it closer to the theoretical ideal of 80% Bonds, 20% stocks.

Currently, this means an approximate 65% allocation to Bonds, 20% to Equities and 15% to investments in Emerging Markets and other asset classes.

Having experienced an exceptional Bull market run for longer than 12 months, our view is Equities have now corrected and **we expect some further appreciation over the coming twelve months.**

The non-bond income generating investments within this portfolio include Master Limited Partnerships and Preferred Stock (higher up the corporate structure than common stock). This should meet the shared **objectives of attractive income with some potential for capital appreciation** in positive equity markets.

CORE Portfolio 3: Moderate Growth with Income Portfolio (MGWIP)

This portfolio is an **alternative to the ‘Traditional’ Balanced 50% Bonds, 50% Equities.**

Why might MGWIP be an attractive alternative?

1. DIAS portfolios are **actively managed**; traditional portfolios tend to be more Buy-and-Hold. In these volatile markets, working with an investment team that has the ability to make changes ahead of a correction, or make timely adjustments after one, could make a big difference.



2. DIAS portfolios tend to be **well diversified**. Using only Stocks and Bonds within a portfolio, as a traditional manager commonly does, is outdated. The modern investment world provides us all with access to many other asset classes from which to generate returns and/or income. DIAS seeks to take advantage of these when thought appropriate.

We feel that **Equities may outperform Fixed Income over the next few years** as Bonds increasingly come under pressure from rising interest rates at some time during this timeframe. Therefore, we are currently overweight stocks and stock-like investments and underweight Bonds in this portfolio.

Increased investment in **Master Limited Partnerships has increased the portfolio yield** thereby balancing the income lost by being underweight Bonds.

We expect this portfolio to become more **popular if and when interest rates start rising and equity markets strengthen**.

On the Equity side, we believe that well capitalized U.S. companies with Global leadership in sectors which are in a positive stage of their market cycle will lead prices upwards. We are cautiously optimistic.

CORE Portfolio 4: Focused Growth Portfolio (FGP)

This is the **DIAS 'mainly Equities' portfolio**. The management of the portfolio, the securities held and the diversification seeks to protect investors from significant market loss; however, the nature of markets means this is not always or fully possible. Investors should expect valuation peaks and troughs. In the event of market losses, the active nature of management will attempt to recover such losses.

The diversification of the portfolio means there may be areas that underperform, which is acceptable providing other areas outperform. The investor should be comfortable with this.

The main investment themes of this portfolio are predicated on:

1. the growth potential stemming from approximately 2 billion new consumers hopping on the capitalism trains leaving stations all across Emerging Market Countries
2. the fiscal strength of many world-leading U.S. companies.

The main headwind facing the portfolio is the debt and credit crises currently being experienced by most developed countries and their banking systems.

Our aim is to navigate these issues and any others as they arise with the aim of providing returns above equity markets, particularly in down markets.

Overall, **we remain cautiously bullish on the prospects for the types of companies and markets we invest in**: those with solid balance sheets and business growth prospects.

EXPLORE Portfolio 1: Inflation Protection Portfolio (IPP)

This portfolio is designed to increase in value as interest rates rise, thereby providing a **hedge against Bond values, which may fall as interest rates rise**. It may therefore be **attractive for investors with a large existing allocation to Bonds** for income purposes but who fear the potential for rising interest rates and inflation. It is, therefore, an ideal partner for Conservative Income and/or Conservative Income with Growth.

Although Inflation has been fairly flat this last 12 months, the value of IPP steadily climbed. Many of the component securities were 'bid up' on the expectation of Inflation, even though inflation didn't move much



at all. Investors should be aware that prices move on Fundamentals AND on Perceptions, not necessarily on hard data alone.

More recently, renewed turmoil has supported Government actions aimed at keeping interest rates lower for longer than we expected. **We are, therefore, currently lengthening our estimates of when interest rates will rise and investing accordingly.**

EXPLORE Portfolio 2: Global Active Alpha Portfolio (GAAP)

This portfolio is designed for investors who require access to additional potential for capital appreciation AND who understand the potential for volatility contained in a diversified, actively managed portfolio of global securities searching for market outperformance. Although this portfolio may outperform U.S.-only Equities and Fixed Income, **high volatility could create a situation where the timing of the initial investment results in an initial period of loss.**

Emerging Markets have enjoyed a period of significant outperformance followed by a period of underperformance. Many of these economies have grown too quickly and are now addressing this by tightening monetary policy. This should be a positive factor in the medium term as all **growth must be controlled to prevent bubbles forming.** However, we expect a bumpy ride for the next few months.

At this stage, the **investor must understand the need to buy and hold this portfolio for the long term to see the long term benefits.** It may not be suitable for investors who worry about prices on a daily basis.

EXPLORE Portfolio 3: Preferred Stock Portfolio (PSP)

Designed for investors who require additional income and are comfortable with the credit risk involved in Preferred Stocks (higher up the corporate structure than Common Stock but still lower than a Bond). However, this portfolio is likely to be more volatile than Fixed Income in turbulent credit markets but probably less volatile than Equities.

In theory, Preferred Stock should have an element of Common Stock appreciation over time AND provide attractive income. This is ideal for investors who are prepared to wait for the appreciation and can withstand an element of volatility.

Note that as prices fall, the yield on the stock rises, providing an opportunity for dollar cost averaging.

Having experienced excellent appreciation in this portfolio, **expectations may be peaking and even getting ahead of reality.**

Turbulent credit conditions exist in developed countries and this may result in the periodic questioning of the whole growth/stability of their economies and companies within.

We would **limit investment in PSP to those investors who require income and are willing to hold the portfolio through the full cycle.**