

Thought for the Week: Monday, April 25th, 2011

Heads you Win, Tails you Win...

Have you ever spent an enjoyable afternoon watching your favorite football team build a solid points lead through three quarters only to see them change their previously effective offensive strategy to a protective **“Prevent Defense”**? Usually, the opposition starts to come alive and the whole game changes.

Personally, it drives me crazy – I usually sit there questioning the mental aptitude of the coach. Why would he do this? Why not keep running the same aggressive approach and blow the opposition away?

But this is the difference between professional coaching and armchair quarterbacking. The coach’s job is to win the game; he goes to **prevent defense to dial down the offensive risk** because it increases the probability of winning. It increases the chances of winning by reducing the potential of quickly losing large chunks of their lead. **It seeks to limit the downside.**

The **“Prevent” concept can apply to asset management** wherein an investment professional may adjust a portfolio to **reduce the risk of losses if the potential for reward doesn’t justify the extra risk**. Just like football, **asset management ‘prevent’ aims to minimize the downside** at the cost of reducing the upside.

Over the last few months, the **equity-based DIAS portfolios have been positioned to dampen any loss** of capital should a correction occur. Our overall goal could be described as “Heads you Win, Tails you Win:”

- If markets continued their bull run, investors in Focused Growth, Active Alpha and Enhanced Income would enjoy some capital appreciation; maybe not to the full level of the index but who is looking to chase the bull at this stage of the cycle?
- If markets suffered reversals, our positioning was aimed at reducing any losses our investors may suffer, which should allow extended gains when equities returned to profit.

The S&P 500 Year-to-Date chart below shows what actually happened.



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 Nothing in this commentary should be construed as a solicitation to buy or sell securities.

DIAS Equity Portfolios Year-to-Date

In the S&P 500 chart above, **arrow 'A' marks the period during which we started to move defensively**. We didn't necessarily "call the market" or make any significant bets. It just looked like equities were becoming over valued and early version of **"Sell in May and Go Away"** may be prudent – a form of Prevent Defense. As a result, we did not fully participate in the peak of late February (arrow 'B' on the chart above).

When first the Middle East unrest hit stock indices, closely followed by Japan, we sat tight instead of selling. We already **had some protection against loss in the portfolios**. Our overall view was Japan was a temporary event but the Middle East issues further weakened medium term stability. Selling into falling prices would not have helped the portfolios.

In mid-March (arrow 'C'), when prices began to recover, our normal approach would be to buy those issues that appeared to be temporarily "on-sale"; those companies that had been unfairly hit. Instead **we used the rise in prices to sell stocks we felt were higher risk and replace with stocks with lower risk**.

We "sold into strength" as our prevailing view was the summer may see more volatility.

The Scoreboard so far

At the time of writing, our defensive positioning has been a little too cautionary. Markets have recovered strongly and have resumed their ascent to new highs. The **"Tails we Win" scenario didn't happen**.

However, our equity-based portfolios still participated almost fully in the upswing: **Heads we Won...!**

Future DIAS Portfolio Positioning

Many media and amateur market commentators talk about the S&P 500 as one single, homogenous entity. They describe its movement as if someone is coordinating the movement of all the stocks. This **gives the impression investors have only one decision to make**: invest in the overall S&P or stay out.

In reality, it's a few hundred stocks that move independently according to their own fundamentals and drivers. An index, such as the S&P, allows us to measure the total movement of all these stocks but it doesn't inform us about each sector and individual stock.

Therefore, saying the S&P 500 is overvalued so don't invest **ignores potential values to be found in specific sectors or companies. It also ignores the excellent income opportunities presented by a number of stocks**.

Currently, stock prices (**valuations**) seem to be keeping pace with increased earnings and careful analysis of companies quoted on major U.S. indices are revealing a number of attractively valued stock selections. **We describe this as a "Stock Pickers" market**.

We are **looking for lower risk stocks which we feel are undervalued** for a variety of reasons.

One significant example is **Overseas Telecoms**. As many emerging and emerged countries experience significant economic growth, each country has a national Telco which is running a virtual monopoly. Owning a smartphone has become one of the most important necessities of modern life. Moreover, Apple has proven the 'Smart' market benefits from replacement revenues and wider product ranges.

It used to be said, the last thing you stop paying is the mortgage. **Now, it's the cell phone bill that's 'pay at all costs' and not the mortgage**.