

August 2011

## Fully Involved

Dear Clients and Friends,

A few months ago I signed up for an online coupon dispensing service called Groupon. Each morning around 4:30 I receive an email giving me the opportunity to purchase something from someone at a nice discount. Not so long ago I purchased enough coupons, or *groupons*, to buy a couple of sandwiches at a sandwich shop – Firehouse Subs. My lovely Callie (18 year-old daughter) and I had supper there the other night and here’s the point - after I selected my sandwich (The Engineer) I was asked whether I wanted my sub “fully involved.” This is a fire-fighting term describing how significantly the fire, heat and smoke have affected a structure.

The sandwich reference to being fully involved had to do with lettuce, tomato, dressings and pickles. In the context of our recent economic, financial, and market turmoil the same query wonders about our portfolio exposures to a plethora of risks that seem to be prevalent in our marketplace.

We have been tweaking our model portfolios since late fall 2009 due to what our metrics suggest: overvaluation in the equity (stock) markets, and concern about a less than optimal risk to reward situation in the bond markets. Our tweakings and leanings are evidenced in three general areas:

### **Shortening of Duration in Bond (fixed-income) Allocations**

I’m not going to try to write a thesis on bond investing here, but the term duration is an informed way of getting an apples-to-apples comparison of the time ‘til maturity of a bond or the average time ‘til maturity in a bond portfolio. The longer the time ‘til maturity, the larger the reaction to changes in interest rates. About a year ago, the duration in the bond side of our model portfolios was about 3.25 years. A stress test of this situation suggests a rise in interest rates of 1% (which has not happened) would cause this 3.25-year duration portfolio to decline in value by about 1.1%. Today the duration of our model bond portfolio is about 2 years. The same stress test predicts no decline in value if interest rates rise by 1%. The prevailing theme for the bond side of our portfolios has always been: “first do no harm.”

### **Emphasis on Dividend and Dividend Growth in Core Equity Allocations**

In the first quarter of 2009 we made changes in the core equity (stock) allocations of our model portfolios for several reasons. An important change was an emphasis (or over-weighting) in equity positions focused on dividends and dividend growth. Today the yield on two significant positions in this section of our core portfolios is a little over 4%. The theme here is “opportunistic,” and anticipates these yields to dampen total exposures to volatility.

**Reduction of General Equity (stock) exposures in Portfolio Completion Allocations**

Although for purposes of providing our clients with portfolio snapshots, the portfolio completion portions of our model portfolios are mostly shown as equity allocations, under the hood there is much more going on. Currently the satellite strategies portion is about 40% equity (the rest bonds); the dynamic allocation portion about 46% equity, and the absolute return portion around 30% equities. So, these three significant positions are less than half exposed to the volatility being exhibited in the equity markets.

We will be measuring again in early September. Equity prices are lower than a few weeks ago and, if this situation remains in place for our measuring work, we may alter our opinions and redirect our leanings a little. Bond prices have actually reacted favorably to the debt “crisis” and the downgrading of treasury ratings – likely due to the reality of an economy in a protracted “slog.”

We - meaning you, me, my mother-in-law and my business partners are exposed to the stock and bond markets. Our portfolio models are unlikely to have positive returns in negative markets. The themes are meant to reduce risk (exposures) in sub-optimal situations and increase opportunities in more optimistic settings. Timing market declines is highly speculative and unlikely to produce benefits. Diversification, paying attention to anticipated cash-flow needs, being sensitive to tax effects, keeping portfolio costs reasonable, and leaning away from risk are reasonable, effective approaches to long-term strategic investing. We’ll keep reading, thinking, listening and working. You call or come see us if you’d like to chat.

God Bless,

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