Tactical Momentum Allocation

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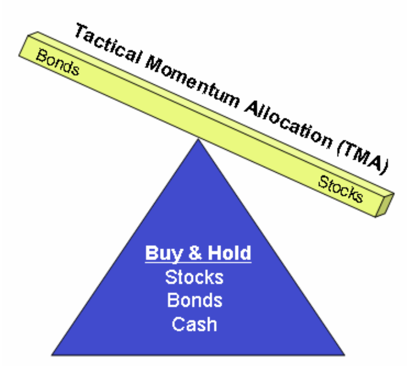
There are two schools of thought in the investment industry when it comes to constructing an investment portfolio. Each group believes its approach is correct and will adamantly and convincingly defend its position. The first school of thought, conventional wisdom, asserts that the best approach to investing is to decide on a fixed allocation, diversify, select investments, and then hold through thick and thin. We'll call this approach "Buy and Hold." The second school believes that a successful strategy requires actively moving a portfolio heavier into stocks or into bonds based on market conditions. This approach requires a facet of market timing, or in other words, following some method of selling stocks and buying bonds and visa versa. We'll refer to this method as "Tactical Allocation." Because we don't know which method will produce the greatest return on a year-to-year basis we believe the best way to enhance performance over a traditional Buy and Hold strategy is to supplement it with a Tactical Allocation strategy.

Each strategy wins when measuring different time periods. For example, in 2008 Tactical won big while in 2006 Buy and Hold (100% stocks) posted bigger return numbers. By blending the two schools of thought together we end up with an overall strategy which consists of an unchanging, static stock, bond, and cash mix and a moving component which tilts the overall aggregate portfolio one way or the other.



Before we look at the advantages of blending the two schools of thought let's examine each strategy and their respective arguments independently and then see how blending them together can enhance performance. We'll start with the four steps in the process of developing a Buy and Hold strategy.

Buy and Hold – Asset Allocation & Diversification

Our buy and hold investment strategies work like this: we determine with each client the percentage of their portfolio to allocate to stocks (or stock funds), bonds (or bond funds), and cash. We primarily make this determination based on when clients will spend the money in their investment portfolio and how much a client will be withdrawing from his portfolio each year. Of course, we also evaluate the amount of risk each client can handle. The percentages allocated to stocks, bonds, and cash remain static and only change as clients get older or as their risk tolerance changes. Once we determine the stock, bond, and cash allocation we further divide the stock portfolio among eight different asset classes and the bond portfolio among four asset classes.

<u>Buy and Hold –Investment Selection & Rebalancing</u>
Then we shop for the most consistent money managers via mutual funds to manage each component of the portfolio. Every six months we meet to review the portfolio. At these meetings we rebalance the portfolio back to the target allocation and make investment management changes when managers prove inconsistent. If a client was properly allocated he didn't do too badly in 2008. For example, a 50% stock and 50% bond portfolio, which is how many of our retired clients are invested, further diversified among 11 different asset classes fell 14% in 2008 while the S&P 500 dropped 37%. Buy and hold investing isn't broken as some 2008 pessimist are attesting, but we think a Tactical Allocation supplement can improve on these results.

<u>The Case for Buy and Hold</u>
If you follow a Buy and Hold strategy you will always be 100% invested in both the stock and bond markets. For example, your stock allocation will always be invested in stocks and consequently you'll be in the market on the days it posts both its biggest gains and losses. Buy and hold proponents cite the "Miss the Best" days returns in Figure 1 as the reason why trying to move your portfolio into or out of stocks will hurt your returns. Being out of the stock market on a few days it goes up the most can devastate your performance. If you are moving your money in and out of the stock market you are likely going to miss many of the best days.

As Figure 1 illustrates, missing just the forty best days in a twenty-five year period would have dropped your annualized return down to almost a negative one percent per year. During the same period the stock market averaged a little over seven percent per year. These *missing the best day* numbers make a compelling argument for staying in the market through thick and thin and maintaining a traditional buy and hold strategy. This approach also reduces the chance of undisciplined investors making decisions based on their emotions. Emotion driven investing leads investors to buy when they feel good, which is typically after investments have significantly increased in value and sell when they feel bad, when an investment has dropped in value. This buy high sell low approach is a great way to lose money.

For these reasons we believe each portfolio should have a Buy and Hold component. We agree that staying in the market and maintaining a buy and hold strategy is the best strategy for most people, especially those who are prone to making investment decisions based on emotion and those without a disciplined strategy.

<u>A Case for Tactical Allocation</u>
Tactical allocation strategies *attempt* to catch a majority of the best days in the stock market but also avoid most of worst days. Now let's answer another question. What would happen if you missed the worst days in the stock market as opposed to the best? By contrast, missing the forty worst days in the same twenty-five year period would have resulted in an annualized return of 17.92%. Missing the worst days had a much greater impact on long term returns than did missing the best days. Figure 2, while a little bit dated, reveals the same results over a longer time period (1926-1993) and uses a monthly time frame instead of daily.

The hope of Tactical Allocation strategies is that at least some of the money you initially allocated to stocks will be out of the market during many of the worst days (under- weighting stocks), and in the market during many of the best days (over weighting stocks). We would not classify this over-weighting and under-weighting approach as traditional market timing which is typically defined as actively making wholesale moves from stocks to cash and visa versa.

Figure 1

Missing the Best and Worst Days (S&P 500)
25-Years (1984 - 2008)

	Annualized Return - Missing the Best Days	Annualized Return - Missing the Worst Days	Missing the Best and the Worst Days
10 Days	4.10%	11.23%	8.15%
20 Days	2.15%	13.80%	8.58%
40 Days	-0.93%	17.95%	8.82%
All 6,306 Days			7.06%

Original study by Telephone Switch Newsletter. Updated through by Hepburn Capital Management.

Figure 2

Missing the Best and Worst Months
68-Years (1926 - 1993)

Time Periods	Annualized Return
Missing The 6 Best Months	9.36%
Missing The 6 Worst Months	14.40%
Missing The 24 Best Months	5.97%
Missing The 24 Worst Months	18.69%
Missing The 48 Best Months	2.86%
Missing The 48 Worst Months	23.00%
Remaining Invested All 816 Months	12.02%
Treasury Bills 816 Months	3.48%

Index: Market Cap Weighted: composite of stocks on the NYSE (1926-93), American Stock Exchange (1962-1993), & NASDAQ (1972-1993)

Who is Right?

Because of studies like these the investment industry is largely divided among strategies that buy and hold investments and those that move in and out of stocks. One side of the industry is religious in its belief that conventional wisdom, Buy and Hold investing, is always better than strategies that change their stock and bond allocations as the market changes course. The other side of the industry shares the same passionate conviction but believes that changing the level of stocks and bonds in a portfolio will improve performance. So who is right? Well, it depends on the historic time period you measure.

Buy & Hold versus Tactical Allocation

Consider the following study that I conducted of domestic stock mutual funds, which generally stay close to 100% invested in stocks (Buy and Hold), and newsletters that recommend allocation changes between domestic stocks, bonds and cash (similar to Tactical Allocation). Figure 3 shows that following the recommendation of the newsletters provided better returns over the past one-, three-, five-, and ten-year periods ending in March of 2009. Most newsletters recommended shifting at least some portfolio money out of stocks in 2008 which dramatically improved long-term performance. Having money out of the market for just about any part of 2008 would have improved performance over traditional buy and hold stock strategies. Tactical Allocation strategies in aggregate kept investors out of the stock market during many of its worst days of 2008.

As you can see, the results are fairly random. There is not a consistent winner or loser when comparing the competing schools of thought during various time periods.

Figure 3

Investment Newsletters vs. Mutual Funds (Tactical Allocation vs. Buy and Hold)

Note: The winner is highlighted in yellow.

	Best:	Worst:	Average
One-Year Ending 3/31/09			
Domestic Mutual Funds 15,258 MFs	2.89%	-92%	-36%
Domestic Newsletters 463 Newsletters	110.00%	-80%	-30%
Three-Year Ending 3/31/09			
Domestic Mutual Funds 12,272 MFs	8.17%	-55%	-13%
Domestic Newsletters 418 Newsletters	12.90%	-88%	-12%
Five-Year Ending 3/31/09			
Domestic Mutual Funds 10,573 MFs	11.73%	-39%	-4%
Domestic Newsletters 355 Newsletters	11.70%	-67%	-3%
Ten-Year Ending 3/31/09			
Domestic Mutual Funds 6,812 MFs	17.60%	-36%	0.05%
Domestic Newsletters 191 Newsletters	14.40%	-30%	2%

Source for Mutual Funds (Mstar, Domestic MFs-all):
Source for Newsletters: CBS Market Watch, Hubert Interactive

Our Answer – Tactical Momentum Allocation

Due to the random nature of the performance of the two schools of thought we've developed a Tactical Allocation strategy to augment our traditional Buy and Hold portfolios. Our Tactical Allocation strategy, Tactical Momentum Allocation (TMA), when blended with our Buy and Hold approach, provides a mechanism to over-weight or under-weight stocks as economic conditions change. While our Buy and Hold strategies held up well under the pressure of 2008, we believe by adding the TMA component to portfolios we have a better chance at increasing returns and decreasing losses. After reviewing the TMA strategy independently we'll review the results of supplementing Buy and Hold portfolios with TMA.

Tactical Momentum Allocation - TMA

In 2008 the TMA strategy resulted in a negative 1.75% return according to our back testing. While no one wants a negative return, investors could have bragged at parties with this negative return, considering the stock market as measured by the S&P 500 index fell 37%.

The goal of the Tactical Momentum Allocation strategy is to identify momentum in the stock and/or bond market and then overweight to the asset classes with the most momentum. TMA buys asset classes once momentum is identified and sells asset classes once momentum diminishes. The TMA strategy attempts to over-participate in extended stock or bond market runs.

Here's how it works. At the end of each calendar quarter the performance of twenty asset classes, ten stock and ten bonds/cash (below), is measured for the prior six-months. The 10 asset classes with the highest 6-month returns are purchased and held for three-months (equally weighted). The process is repeated at the end of each quarter (6-month look back, 3-month hold). TMA Portfolios can be as much as 100% stocks or 100% bonds/cash or anywhere in between based on asset performance momentum. However, TMA always maintains broad diversification by being always invested in ten asset classes.

Stock Asset Classes	Bond/Cash Asset Classes
1-Large-Cap U.S. Growth Stocks	11-Long-Term U.S. Government Bonds
2-Large-Cap U.S. Value Stocks	12-Intermediate-Term U.S.Govt. Bonds
3-Mid-Cap U.S. Growth Stocks	13-Short-Term U.S. Government Bonds
4-Mid-Cap U.S. Value Stocks	14-U.S. Treasury Inflation Protected Bonds
5-Small-Cap U.S. Growth Stocks	15-Long-Term U.S. Corporate Bonds
6-Small-Cap U.S. Value Stocks	16-Intermediate-Term U.S. Corporate Bonds
7-International Growth Stocks	17-Short-Term U.S. Corporate Bonds
8-International Value Stocks	18-High Yield U.S. Corporate Bonds
9-Sector Rotation	19-International Bonds
10-Emerging Markets Stocks	20-Treasury Bills

The results have been impressive (see Figure 4). At this point the results below are theoretical and are based on back testing, not the actual performance of the TMA portfolios we now manage. We actively began managing this strategy in March 2009. Figure 4 shows how the TMA strategy handled past up and down markets since 1999. The hope is that this is an indication of how the strategy will handle future up and down markets. While a 1999-2009 study is not 100% conclusive, it is compelling. TMA was mostly out of stocks during from 2000 to 2002, a period marked by a recession, terrorism, and a war, and also out of stocks in 2008 when the stock market registered its worst calendar year drop since the great depression. Because the TMA strategy missed the bulk of these rocky periods (and worst days) it out performed the stock market as measured by the Standard and Poor's Index dramatically over this time frame.

Figure 4

TMA versus the Stock Market

Year	S&P 500	Growth of $1,000	Tactical Momentum Allocation	Growth of $1,000
1999	21%	$1,210	22%	$1,220
2000	-9%	$1,100	11%	$1,359
2001	-12%	$969	7%	$1,448
2002	-22%	$755	-5%	$1,381
2003	29%	$972	34%	$1,856
2004	11%	$1,078	10%	$2,032
2005	5%	$1,130	6%	$2,161
2006	16%	$1,309	12%	$2,414
2007	5%	$1,381	12%	$2,714
2008	-37%	$870	-2%	$2,667
9/2009*	19%	$1,037	16%	$3,089

* 1/1/09 to 9/30/09

The TMA strategy works only if there is sustained momentum in the stock or bond markets. Based on this, at least conceptually, TMA could have provided some nice asset protection during the Great Depression, since it was a period marked by a very severe and extended, stock market drop.

TMA's Achilles heal are periods when there is no sustained momentum in the stock or bond markets. Figure 5 outlines the changes in the TMA stock and bond allocation over the past ten-years. It's interesting to note that during the first quarter of 2008 TMA moved from 90% stocks to just 20% stocks. During the second quarter of 2008 the TMA allocation reached 100% bonds and remained almost entirely in bonds until the second quarter of 2009.

As you can see, the strategy buys and sells late, or buys and sells after momentum has been sustained for at least six months. The stock market began its slide during the fourth quarter of 2007. However, the TMA strategy didn't begin its shift out of stocks and into bonds until the first quarter of 2008 (sold stocks late). In March of 2009 the stock market began its huge recovery. TMA didn't shift back into stocks until the third quarter of 2009 and consequently missed the initial rebound. Buying and selling late works well over time if the moves in the market are sustained for three to five quarters.

Figure 5

TMA Allocation Changes
Year-to-Year Stock & Bond Allocation

Year	Highest Stock Allocation	Lowest Stock Allocation
1999	80%	30%
2000	80%	40%
2001	30%	10%
2002	90%	0%
2003	100%	0%
2004	100%	30%
2005	90%	40%
2006	100%	30%
2007	100%	80%
2008	20%	0%
*2009	70%	0%

*1/1/09 to 9/30/09

Blending Buy & Hold and Tactical
We diversify our Buy and Hold portfolio over 11-12 asset classes because we don't know from year-to-year which asset classes will provide the best performance. By diversifying, we know we won't be 100% right (picking only the winning asset classes) or 100% wrong (picking only the losing asset classes). Diversification keeps us from making the wrong pick and devastating our portfolio. Diversification is an attempt to smooth out the ride. For the same reason, it makes sense to diversify schools of thought. Since we don't know which school of thought will win each year we opt to blend the two together.

So, let's now blend the two schools of thought together. When we combine the two strategies together the allocation to stocks and bonds in our Buy and Hold strategy remains constant while TMA money is the moving component, tilting the portfolio one way or the other.

To see how this works let's look at a blended portfolio invested one-half in our Buy and Hold strategy and one-half in TMA. The Buy and Hold portfolio, in this example, is comprised of 60% stocks and 40% bonds while the tactical portion of the portfolio can, as we've discussed, shift between stocks and bonds at the end of each quarter.

Figure 6 compares a $2,000 investment made into the S&P 500 and $2,000 invested into the blended strategy. TMA did much better over the entire ten-year period due to the way it handled 2000-02 and 2008, which were both periods marked by a severe and lasting stock market downturn. The last two columns outline the year-to-year performance of the blended portfolio. The blended portfolio produced a 7.52% annual return from 1999-2008 while the stock market (S&P 500) recorded an annualized return of a negative 1.38%. The blended portfolio provided much more return with much less risk during a period marked by two severe stock market slides. Of course past performance is no indication of future results but the numbers are compelling.

Figure 6

Blending TMA and Buy & Hold

Year	S&P 500	Growth of $2,000	Blended Portfolio	Growth of $2,000
1999	21%	$2,421	17%	$2,334
2000	-9%	$2,201	6%	$2,481
2001	-12%	$1,939	2%	$2,520
2002	-22%	$1,510	-5%	$2,404
2003	29%	$1,944	30%	$3,118
2004	11%	$2,155	11%	$3,453
2005	5%	$2,261	7%	$3,679
2006	16%	$2,618	12%	$4,112
2007	5%	$2,762	10%	$4,532
2008	-37%	$1,740	-9%	$4,133
9/2009*	19%	$2,075	17%	$4,817

* 1/1/09 to 9/30/09

Figure 7 shows what the minimum and maximum exposure the aggregate blended portfolio had to stocks each year starting in 1999. Of course, the buy and hold portfolio always remained static at 60% stocks and 40% bonds while the TMA strategy over and under weighted stocks over time. This means if TMA shifts to 100% stocks, as it did in 2003 and 2004 the blended overall portfolio was over weighted to stocks at 80% of the portfolio. However, when TMA went to 0% stocks in 2002 and 2003 the overall blended portfolio during this period under weighted stocks to just 30%. So, with the blend of 60% buy and hold (allocated at 60/40) and 40% TMA the overall portfolio over weighted stocks to a maximum of 80% and under weighted stocks to a minimum of 30%.

Figure 7

Buy & Hold Blended with TMA

Year-to-Year Stock & Bond Allocation

50% Buy and Hold, Allocated 60/40

50% Tactical Momentum Allocation

Year	Highest Stock Allocation	Lowest Stock Allocation
1999	70%	45%
2000	70%	50%
2001	45%	35%
2002	75%	30%
2003	70%	30%
2004	80%	45%
2005	75%	50%
2006	80%	45%
2007	80%	70%
2008	40%	30%
*2009	75%	30%

*1/1/09 to 9/30/09

We don’t know which strategy, buy & hold or TMA, will win in the future. But we are hopeful based on our research that using TMA to supplement our Buy and Hold portfolios will boost returns in a sustained rising stock market and reduce losses in a falling stock market. If we see extended momentum in the stock or bond markets in the future, our research indicates that TMA should work well. In addition, adding TMA allows investors to fight back in a falling market by reducing their exposure to stocks rather than just taking it on the chin with a static Buy and Hold strategy.