Kobren Insight Management
An E*TRADE Wealth Management Company

## Letter From The Portfolio Managers

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# *Year-End Maneuvers*


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Can it be that another year-end is in view? It just seems like the beginning of the summer was yesterday, never mind the beginning of autumn.

It has been yet another interesting year in the financial markets (and we still have two months to go). Despite having to deal with a lot of emotionally wrenching volatility, as investors we ought to be pretty happy with this year's gains so far. If anyone had a crystal ball in January, and could have seen all the news that would unfold this year, we would venture they would have predicted a down market, rather than one on pace for above-average returns.

As we approach a new year, what should investors do to their portfolios? The short answer is that long-term investors shouldn't do a darn thing just because the calendar flips a page. There is no particular reason why one's investment outlook should change on December 31st.

However, the more complete answer is that the end of the year is a good time to practice the discipline of re-balancing your portfolio. Re-balancing your portfolio simply means bringing its asset allocation back in line with your long-term strategic targets. In other words, if your game plan is to have 60% in stocks and you currently have 65% in stocks, then you should sell that extra 5% to get back to your strategic weight. This is often difficult to do – why sell something because it is doing well or conversely buy something that isn't? However, several academic studies have suggested that it can add real value over time. Discipline is rewarded in portfolio management, just as it is at the kitchen table or at the gym.

At Kobren Insight Management, while we will look at re-balancing throughout year, we also employ the discipline of reviewing accounts for re-balancing at year-end. Year-end is a nice time for a combination of reasons, but a big reason is to get the portfolios in a clean, neutral position for the year ahead. Like a New Year's Resolution, it psychologically feels good.

However, in the case of taxable accounts, we may choose not to actually re-balance in the last month of the year, but rather early in the New Year. By waiting only a week or so after we re-balance the non-taxable accounts, we are able to postpone the payment of any taxes on realized gains for a full year. From a tax perspective, that makes good sense.

Another tactic we employ to make re-balancing of taxable accounts more tax-efficient has to do with how we handle mutual fund distributions during the course of the entire year. For non-taxable accounts, the easiest thing to do is to simply have distributions immediately re-invested in the fund. It's convenient and it allows compounding to do its magic. For taxable money, however, it is desirable to have distributions paid in cash rather than be immediately re-invested in the fund. This way, with some cash on hand, it is easier to re-balance the portfolio without having to sell some positions and take realized gains in appreciated securities. While a small thing, this little maneuver should be able to enhance after-tax returns over time.

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## Go Overseas Young Man?

We conducted a conference call on November 1st and nearly 500 of you called in to get our latest update on our thinking for the markets and portfolios. For those who would like to listen to a replay, go to: http://www.kobreninsightmanagement.com/conference_calls/index.html

(Or go to www.kobreninsightmanagement.com and click on the conference calls button on the left side of the home page.)

One topic that came up a few times during the call's Q&A session was the U.S. dollar. Investor sentiment is overwhelmingly negative on the greenback, and for good reason. We are still running massive trade and budget deficits, never mind the fact that the Fed is dropping our short-term interest rates below those of most other major countries (and currencies). There is also the significant threat that countries that hold large foreign exchange dollar reserves, such as China, will move to diversify their dollar holdings by for example, using those dollars to buy euros or euro-denominated securities. All in all, the fundamental background for the dollar does not look good.

It may not seem very reassuring to fight such apparent fundamental problems with clichés, but then again, isn't it interesting how many times the cliché seems to win? (After all, that is how they became clichés in the first place!)

So for those who think it's a lay-up that the dollar will continue to get pulverized and therefore want to put a lot more money in overseas holdings, here come three investing clichés:

"When everybody is on the same side of the investing boat, it is going to turn over."

"It's always darkest before dawn" (admittedly not just an investing cliché).

And, one of our personal favorites:
"The market always moves in the direction that causes the most pain."

While fundamentals do indeed drive the markets in their proper and rightful direction over the long haul, the markets are inherently mysterious, and there are times when they seem to go in the opposite direction of the "facts."

How can this be? Well, sometimes, the facts are already well-known and thus in Wall Street parlance, "baked-in" to the current market prices. In other words, more "confirming news" won't push prices much further in the direction they had been moving. In that situation however, any "disconfirming news" is often a catalyst for a sharp reversal in price. As an example, consider a stock market that is declining over worries about poor job growth. If job reports have been consistently weak for several months, the latest month's weak report won't likely move the market much – it was expected. But if suddenly jobs surged one month – that "contra" evidence could well spark a rally in stocks.

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In some cases, when everyone shares the same view, after a while everyone who is going to act on that view has already done so. If "everybody" is bearish, and has already sold, where is fresh selling going to come from? Then, when prices aren't going down as much anymore, the first seller that covers their position (i.e. starts to buy) may trigger others to do the same. In other words, it is a condition ripe for a reversal.

Besides such a sentiment reversal, what else might cause the dollar to "buck" the trend (sorry for the bad pun, we couldn't resist). While our budget and trade deficits are still bad in an absolute sense, they are improving off their worst levels. Markets tend to follow changes on the margin. "It's the trend, not the level" is yet another market cliché that captures what generally happens in the marketplace.

Another area of potential support for the dollar is its traditional role as a "safe haven" currency. In times of financial stress around the world, many investors have preferred to be in the dollar as opposed to other currencies. However, there does seem to be some debate over whether the dollar is still viewed as a safe haven currency.

The question is fair. Nonetheless, during times of elevated market stress this year, the dollar has actually held up pretty well, if not actually strengthened. So, if for some reason (and there seem to be plenty of them right now) we do witness a full market retreat to high quality assets, whether it be in stocks, bonds, or currencies, the U.S. dollar should do alright.

All that said we still have significant non-dollar exposure in client portfolios. Not only do we have exposure to dedicated un-hedged international equity funds, but we also have non-dollar securities in our multi-sector bond funds as well as in our alternative funds. In addition, we have international exposure through our domestic equity funds. We have an overweight in domestic large cap stocks, and the average large cap growth stock gets nearly 30% of its sales from overseas.

Add it all up and it should be clear that we still favor plenty of international exposure in client portfolios. But given the overwhelming negative sentiment on the dollar, we don't like the risk/reward bet of adding to that exposure at this juncture.

Sincerely,

Eric

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