

---

## LETTER FROM THE PORTFOLIO MANAGERS

---

October 2007

### ***Keeping Your Balance***



Eric M. Kobren

Who says that September is such a bad month for the stock market? Even though September has been the worst calendar month of the year for the stock market (the only month with more down months than up months) since the year 1900, the S&P and Dow Jones Industrial posted their strongest September gains since 1998. The gains last month even put the major indices back on track to post above-average returns for the full year. The market losses from credit concerns just a few months back already seem so long ago.



Rusty Vanneman

Yet, as an accomplished, go-anywhere, fixed-income portfolio manager told us moments ago (after we started this article in fact); this could merely be the eye of the storm. She didn't think the markets would necessarily have to drop significantly, but she did say that there is still a great deal of nervousness out there, and there are credit issues that have yet to be resolved. Her basic recommendation was to diversify, stick to quality investments, and maintain some liquid reserves to take advantage of any opportunities that may develop.

Very sound advice we thought.

Of course, we may have been influenced by the fact that it bears a striking resemblance to the type of classic advice that we like to give ourselves, and currently emphasize in our client portfolios! As you know, we are strong believers in the power of balanced, diversified portfolios that employ gradual, not dramatic, shifts in portfolio strategy and we are favoring high-quality securities in both the stock and bond markets.

At the risk of killing future interest in our monthly letters to you, we none-the-less must point out that any investment outlook is uncertain at best. That is one of the reasons we advocate balanced, diversified portfolios. To heavily skew a portfolio towards an expected economic or market outlook risks a very bad outcome if you are wrong.

And, in any given period, a lot of very bright people are very wrong. So far this year, we have listened to over 500 portfolio manager presentations, and the opinions we've heard range from wildly optimistic to downright depressing, so we know a good many of them will turn out to be incorrect.

### **What (and What Not) to Expect From a Balanced Portfolio Approach**

We also favor balanced portfolios because by mixing the returns of a variety of asset classes they typically deliver steadier returns, with less accompanying emotional highs and lows, making it easier for investors to "stay the course" and consistently participate in the long-term returns of the stock market.

What you should not expect from a balanced portfolio is for its returns to keep pace with a stock market that is rampaging higher. By definition, a blend of several asset classes can not compete with the best-performing asset class.

Continued ...

### It Is Not About Raw Performance

So, how should an investor in a balanced portfolio measure performance? How do they know if their investment managers are doing a good job? While the managers we select for client accounts most often are not running a balanced portfolio in the classic sense, the methodology that we use in evaluating them is actually a very good template to use.

First and most important, we don't select money managers or mutual funds based on raw performance numbers, especially short-term absolute performance. Usually, short-term performance is heavily influenced by random factors. Instead, we focus on understanding their investment philosophy and process and how consistently they execute it. Knowing this goes a long way to allowing us to predict how a fund will behave in a variety of market environments.

This is also far more important to us than knowing their near-term investment outlook. While coverage of managers in the investment media typically revolves around their market outlooks and other attempts at prophecy (we acknowledge that it makes for more interesting stories), it is not all that useful for evaluation. As noted earlier, even very bright managers are frequently wrong about where the market is headed, so clearly something else is driving the returns of those that are successful over the long-term.

A second, and very much related factor, is how "open" a manager or firm is when doing business with us, how well do they communicate. Can we get direct access to portfolio management? Do they give us regular updates on their process, their people, and their portfolio? When the time comes that the fund is not performing well, which at some point happens to all money managers no matter how good they are, we need to be able to dig deeper into the performance drivers and get confirmation of our analysis as soon as we can. Many investment firms do not provide enough information to allow us to fully understand their investment process and therefore get comfortable with their over-all investment service.

Third, we need to understand their business model. What is the ownership structure? How does that impact the resources and the management of the portfolio? What are the financial incentives for the investment decision-makers? How are investment relationship professionals compensated? How is employee morale? Again, while performance tables don't capture this sort of information, it is essential to determine when identifying which money managers to stick with for the long haul.

Fourth, are the costs reasonable for the service provided? At Kobren Insight Management, we examine not just the explicit costs of management fees and expense ratios, but we also look at the "hidden" costs of portfolio turnover and tax efficiency.

In the case of balanced, diversified portfolios, costs should be evaluated against the convenience and the professional services of investment counseling, portfolio construction, and security selection. Many investors may not have the time or temperament to perform each of these functions and stay current with the latest research and market conditions.

Assuming we will be long-term investors with a manager or fund, which is our assumption when we make all of our investments, knowing the answers to these questions make us sleep better at night. Finding money managers who we are confident will stick to their investment philosophies and processes, and provide dependable market exposures, while generating reasonable rates of return at a reasonable cost are not necessarily easy to find, so once we find one, we try to stick with them for as long as we can.

### **Aren't There Any Performance Numbers That Are Useful?**

For those of you who find all of the above a bit too “squishy” and want the comfort of a more quantitative approach to measuring the success of a balanced, diversified portfolio, we need to bring in the concept of risk.

No doubt you are all familiar with the phrase “an investor should take an appropriate level of risk given their goals, risk tolerance, time horizon and their own financial situation.” We recognize that “appropriate” is another soft concept, but thanks to the wealth of academic research and the actual experience of balanced, diversified portfolios, we can determine such a level of risk given one’s particular situation. In fact, while well-known, established money managers might have slightly different twists on how to attack similar situations, their suggested asset allocations tend to have roughly similar risk characteristics.

(As an important aside, it is critical to communicate to us any changes in your investment objectives, risk tolerance or any other personal factors that may impact what the appropriate level of risk you should be assuming in your investment portfolio.)

Once we have established the appropriate level of risk for your portfolio, we can evaluate the level of return in light of that risk. The greater the risk taken, the greater should be the expected return and vice versa. There are a variety of sophisticated mathematical measures of risk-adjusted performance that would probably make your eyes glaze-over. But here’s a simple rule of thumb: a balanced investment portfolio should, at a minimum, be able to generate the same percentage of the stock market’s return as the percentage of its risk assumed. For example, a portfolio that targets half the risk of the S&P 500, should generate at least half the S&P 500’s return.

Sincerely,



Eric M. Kobren  
President  
Portfolio Manager



Rusty Vanneman, CFA  
Director of Research  
Co-Portfolio Manager

P.S. Please mark your calendars for our next Conference Call on November 1st at 7 PM Eastern Time. Dial (toll-free) 866-776-5841 five to 10 minutes before the call and tell the operator that you are joining the Kobren Insight Management Market Review Call.