



To: All TCI Clients

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Back to Basics #2

Understanding Allocation, Diversification and Re-balancing

Your TCI portfolio, regardless of the number of assets used, reflects two major components: safe assets (low risk, low return) and growth assets (higher price volatility, higher potential returns). This is asset allocation at the highest level. A 60/40 portfolio, for example, would have a mix of 60% growth assets (global equity funds) and 40% safe assets (bond funds, CD's, individual bonds, etc). Your advisor's job is to determine through a thorough discovery process how those components should best be combined to help you meet your short-term and long-term goals.

TCI's objective is to always put the smallest amount possible into the high volatility growth assets and still allow you to meet your ideal goals. If you could put all of your money into short-term treasury bills and still be able to retire when you want, spend what you want, and leave what you want for the next generation, then you have no need for the high volatility growth assets in your portfolio. Unfortunately, there are very few people who have this ability which is important to remember. In other words, most all of us *need* to take on short-term volatility to increase the chances we meet all of our future goals.

Within the growth assets there are several different pieces. You own large companies, small companies, domestic companies, foreign companies, value companies, growth companies, emerging market companies, and real estate. This, of course, is diversification. This principle is taken for granted in the investment world anymore, but what does it really mean?

The point to being well diversified is to stay as neutral as possible in regards to making a bet on the market. It all goes back to what we know and we know that broad market returns have historically outpaced inflation and, as discussed before, increase our odds of meeting all of our goals down the road. By making a bet in any direction—by becoming less diversified--you are increasing your odds that you will vary from the long term market return.

Of course this variance could be positive, but is it worth taking the risk? If I said you could make 9% by never making a bet or you could flip a coin where heads equals 11% and tails equals 7%, would you take that chance? The +2% probably just means more money at the end but the -2% may mean you have to work for another 5-7 years or not be able to take those overseas trips in retirement.

So, how do we stay on target for our agreed upon asset allocation? If you pick a 60/40 allocation and don't look at it anymore, you may come back to find out that because of market movements your portfolio has actually become a 70/30 or a 50/50. This is where rebalancing comes in. In the case where the growth assets have outpaced the safe assets significantly and the portfolio grew to the 70/30, you would have to sell 10% of the growth assets and buy safe assets to bring your mix back to 60/40. Of course, this insures that you've sold after a gain on the risky assets in the portfolio. Now that you've rebalanced back to the 60/40, the growth assets struggle and your portfolio drifts towards a 50/50. In that case, you'd have to sell 10% of the safe assets and buy growth assets. Now you are buying growth assets at depressed prices. The process of rebalancing locks in that you will be selling high and buying low more often than not.

More importantly, and where rebalancing really matters, is in neutralizing the biggest risk to you as an investor. Short-term volatility in the portfolio is truly noise—often painful and scary noise, but noise nonetheless. The largest risk you take as an investor is that you go through a period of 15-20 years where the growth assets severely underperform what was expected by staying flat or even being down over that entire period. The only way to possibly grow your wealth in an environment like that is to stick to a disciplined rebalancing strategy.

You hear that the S&P 500 was flat for the last decade, but that doesn't accurately capture the severe ups and downs you experienced along the way. Those ups and downs are opportunities to the long-term investor. If you had followed a disciplined rebalance process, you would have forced yourself to buy growth assets when they were low and sell them after a significant gain slowly growing your wealth along the way despite a "flat" market.

Many of you may have noticed a few more trades over the last couple weeks. After the drop from the political and economic uncertainty, many portfolios had drifted far enough away from their target to justify rebalancing. This time, rebalancing meant selling safe assets and buying more growth assets at depressed prices. Rebalancing forces us to sell growth assets at Euphoria (the point of maximum financial risk) and buy at Depression (point of maximum financial opportunity) and take the emotion out of financial decisions. In all the research we've done, we haven't found anyone that went broke buying low and selling high.

