



## **Adding Value Through Asset Allocation** *A candid look at value in wealth management*

Where does value come from? This is a fundamental question every business must answer to attract and retain customers. Whether your product is coffee, landscaping or industrial machinery, your customers expect to receive value in excess of the price paid. It is no different in wealth management. Clients expect and deserve considerable value for management fees paid. So how, exactly, does Osbon Capital Management (OCM) deliver value?

### **Our view on value**

In wealth management, it is easy to quantify the price paid, but what is the value delivered? How will you be better off if you hire an advisor instead of managing your own portfolio? How will advisor A deliver more value than advisor B? I certainly cannot answer these questions on behalf of the entire financial services industry. But I can speak for OCM. We seek to deliver value in two very specific ways:

- First, we create a completely customized asset allocation for each client. The allocation is based not only on the specific needs, goals and constraints of the client, but on the correlation (or lack thereof) between different asset classes. By strategically mixing classes, we work to reduce total risk for each unit of total return – this is the essence of Modern Portfolio Theory.
- Second, once the asset allocation is set, we carefully select and mix index investments within those classes with the goal of beating asset class benchmarks by 100 basis points, after fees. (See “All OCM Accounts Performance History” at end of article.)

Hiring an advisor is not like buying a car or an appliance. You cannot see or touch the actual investment returns you will earn in advance. You are actually buying a methodology. Through our methodology, we strive to create and sustain tax-efficient diversified portfolios for individuals via indexing. This is OCM in a nutshell, and every one of those words is important. *Tax-efficient*: it’s what you keep not what you make. *Diversified*: diversification helps to preserve capital in difficult times and grow capital in favorable markets. *Individuals*: everyone is unique; there is no one-size-fits-all strategy. *Indexing*: indexing is representational of markets, not predictive. Indexing gives you all markets exactly the way they are, with all their return potential, not necessarily all the markets the way you would like them to be.

### **Indexes?**

Yes, we do all this with indexes. Anyone can index, so why would they need OCM? This is an important question. The easy availability of exchange traded funds (ETFs) and index mutual funds tempts many investors to go it alone, in the same way that racks of electrical supplies at the home improvement center may tempt some homeowners to save money by wiring their own homes. Like connecting two wires together, the mechanics of investing in indexes is simple. But the cost of



making mistakes can be very high. It is exceedingly easy to fill a portfolio with indexes, but much more difficult to ensure that they match one's goals, work well together, and can weather difficult circumstances.

We strongly believe in indexing for the same reason that some advisors dismiss it: when executed properly, it can consistently deliver a return comparable to the market return. Indexing does not chase the exceptional, but it allows investors to participate in the exceptional performance of different markets, sectors and asset types, whenever and wherever they occur. China (FXI), for example, is a standard component of any globally diversified index portfolio, and is up 350% over the last 3 years. Indexing does not try to outsmart or outmaneuver the market. We see indexing as the appropriate and rational response to the Efficient Markets Theory, which suggests that on any given day, each security is priced by the market to reflect all available information. Today's price is fair, and there is no way to know what will come tomorrow – a move down is just as likely as a move up. It's a random walk, as Burton Malkiel of Princeton so aptly described. So trying to beat the market is like betting on the result of a coin flip.

Indexing is often called “passive” investing. Indexing *is* passive when compared to “active management.” Active management seeks to beat the market through timing-driven moves in or out of specific stocks, sectors or asset classes based on research, market trends, political or economic news or, worst of all, hunches. Indexing limits turnover and the expenses and taxes that go with it, but make no mistake, to reap the full benefits of indexing involves many decisions, considerable research and, often most important, the discipline to do nothing when human nature screams otherwise.

#### **Part art...**

The most active aspect of passive investing is the asset allocation stage. The OCM asset allocation model works from the bottom up and the top down. Evaluating GRITT – goals, risk, income, taxes and timeframe – is the bottom-up component. Through this process we come to understand the client's current financial situation, aspirations, family and other parameters. Our objective is to achieve client goals in a way that is consistent with their beliefs, principles, personality and tolerance for risk, so knowing the client is essential. This is really the art of asset allocation – recognizing what fits with the client.

#### **Part science...**

The science of asset allocation is choosing worthy investments within each class. There are more than 500 ETFs available. Some are well made; some are poorly designed, inefficient, and expensive. After extensive due diligence, we have selected about 60 equity, fixed income, and alternative ETFs for our portfolios that we consider the best of the best, based on structure, accuracy, tax-efficiency, costs, and their ability to represent specific investment criteria – benchmarks, regions, styles, sectors and capitalization. (See our article, “How to Index,” for details.)



Using these 60 ETFs, we've created 10 core portfolios, where each profile corresponds to a fundamental strategy. Some portfolios are broad, such as "global diversification." Some are narrower, such as international equity, income or value. We even have a very intriguing "contrarian" index portfolio and an "alternative investments" index portfolio.

Matching a client's GRITT picture to one of our 10 core portfolios is the first step in the customization process. From there, we "flavor to taste" – adding or deleting elements to meet the specific goals and preferences of each individual investor. Often this customizing can be accomplished using index instruments; when it's not, we have access to virtually any market in the world to fill the need. We also choose the risk level – conservative, moderate or aggressive – that best fits the investor, and adjust their core portfolio accordingly, as described below.

### **Part hardcore math**

Here's where a Ph.D. in mathematics comes in handy. Consider the income portfolio. It may contain 20 different index investments, each with its own risk and return characteristics. Modern Portfolio Theory teaches that by changing the distribution of money across those 20 different indexes, we can alter the risk and return characteristics of the portfolio as a whole. This fine-tuning optimizes each portfolio – determining the ideal mix and weighting of indexes for different levels of risk and return.

Optimization is the most difficult and most valuable aspect of asset allocation – one that almost no individual investor and few investment advisors can execute. Our math master, Ian Johnson, does our optimization work. Ian focuses on determining what mix of indexes in each of the 10 core portfolios can work to produce the highest return at three distinct levels of risk: conservative, moderate, or aggressive. Risk profiling – matching risk to return – is a unique feature of OCM's process. The net result is a personalized asset allocation and portfolio for each client – a risk-tuned variation of one of our 10 core portfolios, further customized to the individual's tastes and preferences.

Because all of this work requires considerable time, interest, data resources, computing power, specialized skills and discipline – inputs that few investors are willing or able to devote – it is the heart of our value proposition. We simply work harder and dig deeper in our efforts to grow and protect assets.

### **Value is perceived**

OCM is a young company. Our track record spans only a few years. To draw any conclusions strictly from our performance results would violate one of the cardinal warnings in investing: "Past performance is no guarantee of future results." Nonetheless, I am very encouraged by our results. We have exceeded our goal of beating asset class benchmarks by 100 basis points, after fees, since inception. This tells me that our methodology is working – producing value for our



clients – and I expect it will continue to work because it is based on reasonable goals, common sense and attention to detail.

I am also the first to point out that what *I* say about the value that OCM delivers means very little. Value is perceived, and perception is reality. Value is delivered, not declared. If our clients don't see the value, then it doesn't exist. The true measures of client satisfaction – referrals, additional capital contributions, and moving up in rank relative to our clients' other managers – suggest that our clients do see value in how their OCM portfolios are managed.

Some investors may look at our approach and draw different conclusions. There are clearly many ways to keep and grow money (and at least as many ways to lose it). No one way is the absolute right way, and some investors will perceive greater value in other methods. To my eye, focusing efforts on asset allocation and indexing is the best course of action. Whether you index 100% of your portfolio, as I do, or 10% as an index skeptic might, by indexing you will set a risk adjusted, after-tax return standard against which all other parts of your portfolio can be measured.

John Osbon, Chief Investment Officer  
December 2007

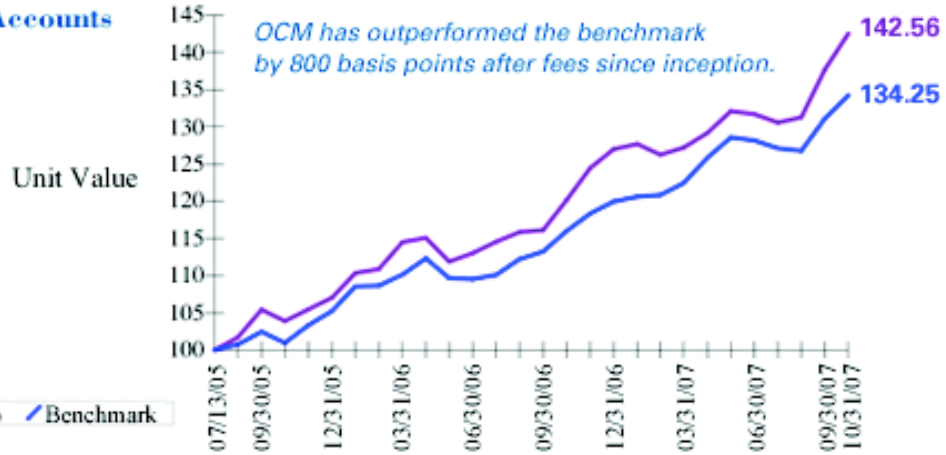
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**Graphical Performance History**

From 07/31/2005 to 10/31/2007 • Net Returns

**All OCM Accounts**



(Benchmark = 55% DJ World Stock Index, 29% Lehman Brothers Munis 7-Yr, 11% Hennessee Hedge Fund Index, 5% Cash)

**Performance Analysis**

**All OCM Accounts**

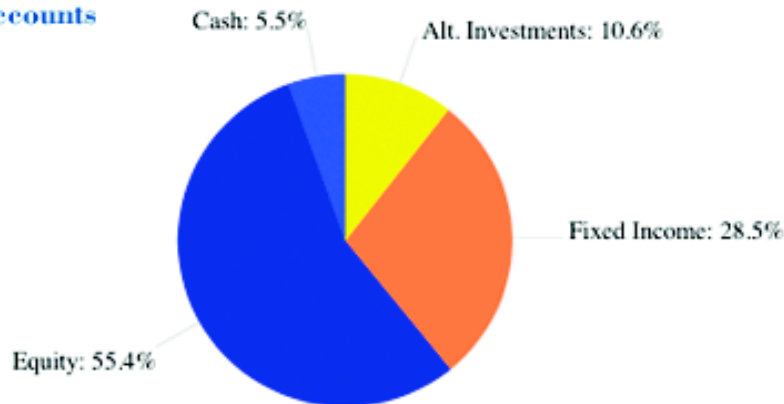
Money invested with OCM has compounded at 17% annually after fees since inception.

Total Portfolio	Current Quarter	YTD	*Since Inception
Time Weighted (net)	3.51	12.25	42.56
Annualized			17.05
Standard Deviation			
Portfolio			6.09
Sharpe Ratio			
Portfolio	..	..	2.08

**Portfolio Allocation**

As of 10/31/2007

**All OCM Accounts**





The Osbon Capital Management (“OCM”) Composite Portfolio represents the combined performance of actual OCM client accounts in existence from July 31, 2005 to October 31, 2007 utilizing the various OCM proprietary investment strategies. The accounts included in the OCM Composite are invested in a range of investments suited to individual client objectives, risk profiles and time horizons. These investments can include a combination of individual stocks, bonds, options, mutual funds, exchange traded fund and other instruments managed with a view towards income, total return and/or capital appreciation.

The performance results of the OCM Composite Portfolio are net of actual fees charged to client accounts, brokerage commissions and other expenses. OCM’s investment advisory fees are described in the disclosure statement of Part II of OCM’s Form ADV which is available upon request. The performance results of the OCM Composite Portfolio include the reinvestment of dividends and other earnings. Comparison of the OCM Composite Portfolio to the stated benchmark is for illustrative purposes only and the volatility of comparative benchmarks may be materially different from the volatility of the OCM Composite Portfolio due to varying degrees of diversification and/or other factors.

Past performance of the OCM Composite Portfolio may not be indicative of future results and the performance of a specific individual client account may vary substantially from the composite results above in part because client accounts are customized based upon each client’s varying investment goals, time horizons, and risk tolerances. Different types of investments involve varying degrees of risk, and there can be no assurance that any specific investment will be profitable.

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