



Investment Fitness

Five steps to enhance portfolio resilience, flexibility, and stamina

The time to get in shape is before you need to. It's true at the gym, and it's true for investing: When things are going well, you don't pay too much attention to your fitness level, but when your body – or portfolio – faces a challenging obstacle course or endurance test, you need to be deeply prepared. In advance.

At Osbon Capital Management (OCM), we don't forecast the economy or predict markets. The market may continue its five-year bull market. Or the weak dollar, record high oil and gold prices and the disrupted real estate market may send markets reeling. We don't know, and anyone who claims to know is guessing.

What we do know is that a daunting downturn is always a possibility. Every portfolio should be ready for that possibility, now and always. Because there's no way to know when challenging times are near, portfolio fitness should be a priority for all investors, all the time. ([click here to read more](#))

How's your fitness level?

What does investment fitness look like? In my view, fitness cannot be judged by results in climbing markets. Fitness is not the ability to ride a happily rising tide. Fitness is readiness – readiness to weather difficult, discouraging markets. Fitness means:

- Resilience – the ability to withstand shocks and rebound or even advance through them
- Flexibility – the ability to adapt to unforeseen conditions as necessary
- Stamina – the ability to win over the long term, in a variety of conditions

Here are five key steps we view as imperative in helping to build valuable financial fitness:

#1 Recognize and control leverage

Leverage is an invisible, powerful, and potentially dangerous, accelerator. It propels a portfolio faster and farther – in any direction. Highly levered investors can find themselves on a wild and unmanageable ride. Too much leverage can be like the family SUV slaloming the country roads at 120 mph – thrilling perhaps, but beyond reasonable control.

Leverage comes in many forms, some intentional, some only apparent after a wreck:

- **Margin** – Borrowing specifically to invest may add return to your portfolio, or may not. It will almost certainly add drama – higher highs and lower lows. For wealthy individuals investing for the long term, leveraging via margin falls somewhere between not necessary and not advised, in my view.



- ***Hidden leverage*** – If you have a mortgage and an investment portfolio, you are effectively borrowing to buy investments. The mortgage tax deduction reduces the cost of borrowing, but the impact is the same as investing on margin – additional risk. Seth Klarman of Baupost was among the first to warn against the growing use of the home as a personal piggy bank. His caution, first offered in the 1990s, still rings true. We don't necessarily suggest that clients liquidate investments to pay off mortgages, but want all investors to recognize the hidden leverage that a sizable mortgage adds to one's overall financial portfolio. It's margin in disguise.
- ***Semi-hidden leverage*** – Hedge funds and private equity are the unapologetic racecars of the investment world. They aggressively lever up to enhance upward potential and the speed with which it may be attained. I never met a hedge fund that wasn't levered; most stack the odds by 1x to 5x. Likewise, private equity embraces leverage. The latest mega-deals are levered 3 to 1, according to David Rubenstein, head of Carlyle Group. We often utilize hedge and private equity investments in our client portfolios, being careful not to exceed the 15% limit we set for non-index investments; they can increase diversification and the opportunity for an occasional big win when other investments are flagging. But in a fit portfolio, there's only so much space for vehicles that move this fast. The price of error can be high.
- ***Even more hidden leverage*** – When you own low quality debt, you are buying exposure to the issuer's own steep leverage. Terms like "junk," "high yield," "turnaround," and "distressed" are all indicators of high debt levels. There are times to own low quality investment instruments (generally when economic times are dire, on the theory that things can't get any worse and all the bad news is already reflected in the price) but when debt risk is combined with business risk, the effect is magnified, and investment fitness is compromised. Be aware and wary.

#2 Affirm asset allocation

Asset allocation is the most powerful tool available to influence portfolio risk and return, and to link the two together. Its importance is paramount – both for general portfolio performance and for investment fitness. Allocation levels should be consistently monitored to avoid any of the following:

- Reaching for return
- Failure to adjust to changing financial needs or goals
- Unintended correlation/overexposure
- Imbalance caused by changes in market value
- Lapses in discipline ("story stocks," "for you only" investments, etc.)
- Funds or managers experiencing "style drift"



A regular quarterly report on asset allocation can identify warning signs. This scrutiny is an essential element in striving for investment fitness.

#3 Be the market

Experience is the ultimate teacher. My experience working with high net worth individuals and families continues to reinforce my own belief that attaining performance results that match the overall market over a generational timeframe is highly desirable – much more desirable than an occasional huge win amid frequent disappointments.

At OCM, we strongly advocate indexing – a low cost, low tax approach to pursuing market return. We typically allocate 85% or more of each client portfolio to indexed investments, with speculative investments strictly limited to match the investor’s appetite for risk. Trying to outsmart the market through market timing is not investing; it’s predicting. We avoid it and encourage investors to steer clear of market timing, especially when investment fitness is the goal. Trying to jump in and out of investments during turbulent times is tempting, but, in my experience, rarely advantageous.

The OCM Advantage – Investment fitness is a priority at OCM. We continually scrutinize our client portfolios for inappropriate asset allocation, excessive leverage and other elements that may hinder resilience, flexibility and stamina in challenging market conditions.

Happily, average does not mean low. At OCM, we believe that a carefully diversified portfolio of low cost, tax-efficient index investments that matches the average return of the overall market can help to produce admirable long-term results. The building blocks for such a portfolio might include Europe (9.1% annualized per year for the last 10 years), Latin America (12.5%, /10 years) and India (16.1%/10 years).*

#4 Rationalize and simplify

I strongly believe in an intelligibility test for investments. If an investor cannot understand and easily articulate what he or she is investing in, it’s a bad choice. There are too many sound, smart, and intelligible investment choices available to resort to securities that confuse or surprise.

* Ten-year annualized returns are courtesy of MSCI-Barra. Past performance cannot predict future results, of course.

#5 Favor liquidity

In difficult markets, flexibility is a valuable comfort. An inability to adjust holdings due to a lack of liquidity (the ability to sell at any price) or marketability (the ability to sell at a fair market price) limits flexibility, and may raise blood pressure. Because some investments are intentionally structured as long-term and relatively illiquid, our view is that investors should only hold them if they can accept these constraints. Hedge funds and private equity investments are structured as limited



partnerships for a reason – to attract long term investors. These investments are meant to be bought and held, not liberally traded. In pursuing fitness, we suggest limiting the exposure to less-than-liquid investments to a small portion of one’s portfolio.

Investment Fitness Checklist

	Resilience	Flexibility	Stamina
Signs	Close tracking to target or benchmark; less volatility – OCM uses Etelligent for absolute and relative reporting	Ability to adjust strategy easily; as expressed by liquidity and marketability	Connection between expectation and reality; performance consistent with goals
Tests	Bloomberg stress test(1)*	Standard deviation*	Sharpe, Sortino ratios(3)* – measures unit return per unit of risk taken
Exercises	Value added of asset allocation(2)	Liquidity and marketability check*	Correlation coefficient(2)* – variation of portfolio relative to the market

* available through OCM for your portfolio

- (1) Bloomberg Stress Test WRST<go> -measures your portfolio’s potential loss associated with extreme market conditions
- (2) Calculated by Etelligent (verify)
- (3) Calculated by Etelligent (verify)

Fitness is no accident

Just like the human body, a portfolio will only reach a high level of fitness through intentional, disciplined decisions and actions. Sophisticated analytical tools allow careful screening for diversification, risk and other key measures. We employ these tools, as well as the benefit of experience, to systematically build resilience, flexibility and stamina into our client portfolios.

Here’s a fitness question worth asking now, before you need it: Is your portfolio ready for whatever obstacle course may be around the next corner?



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