



Portfolio Architecture

Building and maintaining your investment house

In investing, like construction, choosing high quality inputs is critical. But just as important is the building design, and the detailed architectural plan that defines how materials will be combined and assembled to create the desired result. Last month we described how we choose exchange traded funds (ETFs) as the essential building blocks of modern portfolios. This month we turn from materials to design – the architecture that makes portfolios strong, safe and comfortable, even in demanding market conditions.

The investment philosophy at OCM is simple: utilize diversified, tax-efficient, low cost index investments to protect and grow capital over generational timeframes. We remain fully invested at all times, avoid market timing and ignore market fads. Even with these simple guiding principles, designing and building portfolios is a complex and demanding enterprise. Our process, with many parallels to architecture, follows seven essential rules:

1. Make it personal – Customized architecture begins with the client’s needs and dreams. Will the structure be a starter home, a family estate, or a dramatic vacation getaway? Portfolio planning begins the same way, determining the client’s specific investment goals, income needs, time horizons, risk tolerance, tax status, and other variables. Only when these factors are discussed and understood can the design process begin.

2. Consider trade-offs – A house made entirely of glass may offer unmatched views, but only at the cost of fragility, extremes in temperature and lack of privacy. Likewise, an all-steel structure provides extreme protection while sacrificing comfort and aesthetics. The most appealing structures – and portfolios – blend many inputs to deliver comfort and protection in a wide range of conditions.

Carefully mixing asset classes is at the core of effective portfolio design, as studies indicate that the selection of asset classes has a far greater long-term impact on portfolio return than does the selection of securities. That is, setting the allocation between US and emerging market equities will typically influence results more than choosing Apple over Microsoft, or Exxon Mobil over BP.



The three broad asset classes we use at OCM are stocks, bonds, and alternative investments. Bonds are subdivided into taxable, tax free, international, and inflation protected (TIPS). Equities are divided into US and non-US. Alternative investments – hedge funds, commodities, gold, and real estate – are generally limited to a maximum of 15% in any portfolio.

3. Understand the specs – Before choosing slate, asphalt or tin for a roof, an architect carefully considers product specifications and test results that describe many variables, including weight, strength and durability.

In investing, we do not have the luxury of hard data that defines exactly how an asset class will perform over time. What we do have is market history – the actual returns of each asset class for at least ten years. Ten years is long enough to capture the volatility of returns caused by recessions and by bubbles. In the last ten years we have had two bubbles – tech and real estate – and now two recessions. We collect the daily price of each asset, or its index proxy, for ten years. This gives us about 2500 data points for each asset type.

From that data we can calculate our two most essential facts: annual return and annual volatility. Return tells us what we might get, volatility tells us how big the ups and downs can be along the way. Now, experience (and disclaimers) tell us that past performance does not predict future results. However, results do tend to converge to the mean – over the long term, returns tend to center around a number, although that number can vary widely from year to year. Each asset class has its own unique levels of long term historical return and volatility, which offer guidance, not guarantees, regarding long-term future results. Mark Twain said it best: “History doesn’t repeat itself, but it does rhyme.”

4. Recognize hidden risks – Every building project and portfolio involves risks. Some can be avoided. Some can be controlled. Others must be accepted. But ignoring risks that lurk in the dark is dangerous.

A significant threat often overlooked by investors is currency risk. A portfolio denominated in a single currency swings not only on the performance of securities within it, but also on the value of that currency. As the IMF reports that the dollar comprises 65% of all outstanding currency, we use that as our benchmark for portfolio composition, keeping 55-75% of assets in dollar investments. Any greater deviation, whether intentional or not, is, in our view, essentially speculation in the dollar. Non-dollar investments offer both a hedge against a significant decline in the dollar, and valuable diversification benefits.



5. Apply the science – Architects and engineers trust the proven rules of materials science and physics as they design structures. We trust the elegance of Modern Portfolio Theory (MPT), which posits that one can mix risky assets together to increase total return and decrease risk.

Harry Markowitz won the Nobel Prize for his paper on MPT. His work lays out a formula for defining the ‘efficient frontier’ – the combinations of risk and return where return is maximized for any given level of risk. We apply the math behind his work to execute a Mean Variance Optimization (MVO) for every portfolio. This is the math whiz part. In a nutshell, MVO leverages the 2500 data points described earlier to tell us if we could change the asset allocation of a portfolio to potentially achieve a higher expected return without increasing the expected level of risk. If not, the portfolio is on the efficient frontier; it is optimized.

While the math is complex, this process is the core of portfolio architecture at OCM. For any level of risk an investor is willing to accept, we can tune the distribution of assets to multiple asset classes to maximize expected return. Without MVO analysis, an investor is assuming more risk for a given level of expected return than necessary, or said another way, is accepting a lower level of expected return than is justified by the risk level.

The OCM advantage:
Osbon Capital Management custom designs each client portfolio individually, selecting a mix of index ETF investments that provides broad diversification and tax-efficiency at low expense levels. Most importantly, we apply Modern Portfolio Theory to balance risk and return.

6. Apply the art – The professional judgment of an architect helps to avoid undesired outcomes, such as designs that are technically sound, but impractical for daily living. In investing, we apply reason and judgment to avoid extremes that may erode long term performance. For instance, we set parameters and cross-check portfolio composition by four key factors – capitalization (Small, Mid, Large), sector (Energy, Healthcare, etc.), style (Growth, Value), and geography (US, Europe, Japan, Etc.) This intentional diversification helps to avoid overexposure to negative events in any single industry or type of security.

7. Maintain the design – Exposed to changing conditions season-to-season and year-to-year, both buildings and portfolios require continual review and care. We regularly rebalance portfolios when personal circumstances change, when market prices change, and with the passage of time.



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The final test

By definition, we all live and work in architect-designed buildings. We come to appreciate that some architects are better than others, however, and that some styles are better suited to us personally. After all the theory, data, and calculations, living in one's investment house is a matter of personal and financial comfort. How do you know your own investment house is right for you? The answer is subjective and unique to each of us. The simple tests are: you sleep at night, you know where the plans are, and you have someone to call in case of questions or worry.

John Osbon, Chief Investment Officer
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