

INOCULATING PORTFOLIOS AGAINST CONTAGION **Using Dynamic Asset Allocation and Portfolio Protection**

* * *

This is one of a series of Research Briefs created by Brinton Eaton to keep our clients informed about key developments — in financial planning, tax strategy, and investment management — that we research and implement as appropriate on your behalf.

Well-executed asset allocation and diligent portfolio rebalancing have been, and remain, the essential elements of long-term investment success. But there are those rare occasions, such as the fourth quarter of 2008, when even the best-designed portfolios can be devastated by a phenomenon called contagion.

Contagion describes that very infrequent market condition wherein typically unrelated asset classes all decline in unison. When that happens, portfolio diversification is rendered temporarily impotent.

Portfolios infected by contagion can sicken investors because of the cruel inequity of market cycles. A 10% decline in a portfolio's market value can be remedied by an 11% advance. But a 25% drop requires a 33% increase to recover; and a 33% decline requires a 50% recovery. In most market cycles, asset allocation and rebalancing can protect you from the downside while allowing you to participate in the upside. But not when contagion hits – that's when you are virtually defenseless against the fall.

Contagion on the scale of late 2008 is rare, but it can happen again, at any time, and with no warning. Even in the subsequent recovery cycle, markets exhibited troubling signs of contagious behavior, with stocks and commodities, for example, moving in virtual lockstep for extended periods. Investors are well advised not to be caught unprepared the next time contagion becomes epidemic.

But there is good news. Dynamic asset allocation and explicit portfolio protection are two effective defenses against contagion.

Dynamic Asset Allocation

Dynamic asset allocation is a proactive strategy that uses economic and market signals to guide the nimble restructuring of portfolios to protect them from serious damage. The identification of reliable signals, and the development of the appropriate responses, are matters of intense research and analysis, which can never really end. But the solution does not need to be perfect to be effective, and partial solutions can be put in place while even better approaches are still under development.

A potential problem with dynamic asset allocation may be one of perception. It may look from the outside like "market timing," which Brinton Eaton does not subscribe to, and which Jerry Miccolis, Brinton Eaton's chief investment officer, excoriates in his book *Asset Allocation For Dummies*[®] (Wiley 2009). Market timing is the attempt to beat the market by trying to guess when to get in and get out, often using gut instinct. Dynamic asset allocation, on the other hand, remains rooted in staying fully invested with a well-diversified portfolio, but making defensive maneuvers when scientifically tested and reliable indicators signal the need to do so.

Dynamic asset allocation is a risk management strategy, not a get-rich-quick scheme. It does not violate Modern Portfolio Theory or repudiate the sound economic and financial principles behind asset allocation, as most market timing attempts do. It simply embraces *more* of those principles – such as the fact that asset class correlations are not static, but are prone to contagion. It is part of the next generation, a more sophisticated version, of asset allocation.

Portfolio Protection

But even a nimble, dynamic approach to asset allocation is not, by itself, sufficient to protect your portfolio against the most extreme downturns. You need to layer in a “safety net” beneath it.

There are all manner of portfolio protection products in the market, from protective puts (options, or derivatives, that appreciate in value as an underlying security or index, such as the S&P 500 Stock Index, declines) to “inverse index funds” (that behave similarly to puts when the underlying index declines, but, unlike puts, decrease in value when the subject index increases). There are even ways to invest in market volatility itself, to exploit the tendency for volatility to spike when markets suddenly drop. However, most of these products are very expensive (not just directly, but indirectly, by sacrificing your upside portfolio potential) and/or have value that is transitory, in that whatever appreciation the product generates in the down cycle is given back when markets rebound.

Brinton Eaton has developed an approach that does not suffer from those drawbacks. It relies on the EMERALD Index, designed by Deutsche Bank. EMERALD is essentially a “volatility swap” that exploits a clearly observable phenomenon about equity market behavior, namely that the S&P 500 Stock Index’s movement from week to week is typically less than its daily movement would imply. In normal markets, this generates modest growth in the EMERALD Index that is expected to pay for the product’s cost. In extreme markets, the index is expected to appreciate dramatically, and to hold onto that appreciation when markets eventually recover.

This solution was made available to Brinton Eaton clients through a custom-designed structured note from Deutsche Bank. More detailed information can be found on our website www.brintoneaton.com.

Immunizing Your Portfolio

Think of dynamic asset allocation and portfolio protection as an inoculation against contagion. We cannot guarantee 100 percent protection, but we believe these approaches are sound, well-designed attempts to win by not losing.

* * *