

brinton eaton
beyond wealth management



**Does
Your Portfolio
Have A
Safety Net?**

Does Your Portfolio Have A Safety Net?

In the Fall of 2010, Brinton Eaton conducted an online survey on the subject of portfolio protection. We received over 200 responses. The results are summarized in this report, and a compilation of responses to each survey question is included in the appendix.

The results of the survey show that respondents have a strong understanding of safety net protection and place a high value on it, in some cases willing to overpay for it.

The survey also confirms that despite recent market turmoil, investors are staying focused on investing for the long term and have not lost faith in portfolio diversification. They do realize, though, that something more is needed in times of extreme market stress.



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Key Findings and Observations

1. Portfolio Protection is Well Understood and in Demand

81% of respondents had a clear and common definition of what portfolio protection means — “protection from a severe market crash” — and over 75% reported that their knowledge of portfolio protection techniques was “fair,” “good,” or “excellent.” More than 90% of respondents said that portfolio protection was at least “somewhat” important, with 72% indicating that it was “important,” “very important,” or “essential.” When asked how market events over the last two years affected their interest in portfolio protection, 96% stated that they were at least as interested if not more interested than before, with a sizeable majority (62%) reporting a growth in interest.

2. Cost Is No Object

Almost 80% of respondents are willing to spend 1% or more of their portfolio on protection, with fully 38% comfortable spending more than 3%. With respect to indirect costs, more than three-quarters of respondents would be willing to sacrifice some upside potential to defray the direct cost of portfolio protection.

3. Investing Patiently for the Long Term Is the Theme

Over 90% of respondents indicated that their investment horizon extended for at least three years, with a majority identifying their horizon as 10 years or longer. This was true across a wide range of (self-described) investment sophistication, and also across all investment philosophies from conservative to aggressive. This is consistent with the finding that a large majority of respondents (over 70%) reported that their response to the market collapse of 2008 was to “hold and wait for the portfolio to rebound,” which, of course, it did — for those who stayed the course.

4. The Death of Diversification Has Been Greatly Exaggerated

When asked if the 2008 market collapse caused respondents to lose faith in portfolio diversification, a substantial 75% said “No”. Not surprisingly, this percentage was even higher for those who described their investment knowledge as “good,” “very good,” or “sophisticated.” The percentage also was generally higher among more aggressive investors.

Our Reactions and Conclusions

1. You Win by Not Losing

As important as asset allocation and rebalancing are (see item 4 below), more is needed, as there will be the rare occasions when diversification is rendered temporarily ineffective by too many asset classes declining at once (a phenomenon called *contagion*). That is the role of explicit portfolio protection. Given the cruel inequity of investment gains and losses — for every 1% decline, a greater-than-1% advance is necessary to break even — the way to long-term wealth is to avoid the big declines, i.e., to win by not losing.

2. Cost-Efficiency is Achievable

While our respondents are apparently willing to spend more than 1% (and in some cases, substantially more than 1%, even more than 3%) of their portfolio on protection, we do not believe the costs need be that high for an effective solution. Furthermore, we do not believe it is necessary to sacrifice any upside potential to defray the cost. For these reasons, Brinton Eaton has included “very low cost” as one of the three criteria we have established to help us screen potential solutions¹ (see page 4).

3. Investing for the Long Term Pays Off — Again

The markets have recovered from all prior declines, as indeed they have done after the momentous collapse of late 2008/early 2009. It is imprudent to bet against this phenomenon. As has always been the case, the only participants significantly hurt by the markets' gyrations over the last two years were those that abandoned their long-term investment strategies — either by moving a substantial portion of their portfolios to cash or by moving to a considerably more conservative strategy.

4. Asset Allocation is Still King

It remains the case that your investment results will be determined by your asset allocation — that is, which asset classes you invest in, and in what proportions. It is, in fact, more important than ever to be broadly diversified in as many non-related asset classes as feasible. And, each day, more portfolio diversifiers are becoming available to alert investors. Your advisor should be devoting significant time and attention to asset allocation and its companion, portfolio rebalancing, which keeps your portfolio true to its intended allocation and, executed properly, can actually increase return and decrease risk.



I subscribe to maintaining asset allocation, for my risk tolerance, through regular rebalancing.



I now understand the importance of protecting against the small but finite probability of contagion.

quote from a respondent

Our Three Criteria for Portfolio Protection

In our work to protect client portfolios, Brinton Eaton has developed a clear sense of what we want, and do not want, in a solution. We have codified these standards in a set of rigorous criteria. They are:

Sudden Appreciation in Severe Market Downturns

We want the solution to *suddenly* appreciate when markets suffer *severe* downturns — suddenly, because when disaster strikes, you usually don't have the luxury of time to plan and react. By "severe" here we mean a sudden, substantial, unexpected decline in market value across most major asset classes, as in the fourth quarter of 2008 (i.e., when diversification doesn't help). You don't need to explicitly protect against "normal" bear markets — you should already have that covered by asset allocation among non-correlated assets, and rebalancing. What we're looking for is protection against those rare events when those correlations "go to one", i.e., when everything falls off the cliff at once; when contagion occurs; when diversification fails. We want that appreciation to occur to a degree sufficient to meaningfully offset the decline. Importantly (and this eliminates a lot of potential solutions, such as put options), we want no "give-back" during market recovery! Once the appreciation occurs, we want to hold on to it forever, not give it back when markets recover, as they always eventually do.

Very Low Cost

We want the solution to cost as little as possible, since, after all, the situation we're trying to protect against is extremely rare. The idea is to minimize the diversion of funds from productive use inside your portfolio. Those "mainstream" investments are in your portfolio for a reason — to grow enough to fund your future — and we don't want to divert funds away from them. In addition to direct costs, we want to minimize indirect costs as well. That is, *we do not want to sacrifice upside portfolio potential*. The last thing we wanted to do to our clients in the wake of the market collapse in 2008/09 was to deprive them of any part of their opportunity to have the market give back what it took from them. (This is why we do not believe option collars are effective solutions.) In other words, the cost of the solution should reflect the fact that it is essentially "insurance" that we hope and expect not to use. The ideal here is "costless catastrophe insurance."

Minimal Disruption to Portfolio

We don't want the solution to disrupt what works in the overwhelming majority of market environments we are likely to see, in pursuit of protection against extremely rare events. Carefully designed asset allocation and rebalancing systems — that have been proven to work in "normal" markets, both good and bad — should not be dismantled. In other words, we want to be careful not to throw the baby out with the bathwater.

These criteria are, collectively, extremely difficult to meet and, not surprisingly, most solutions in the marketplace fail to satisfy one or more of them. But there are solutions that come very close to meeting all three of our criteria².

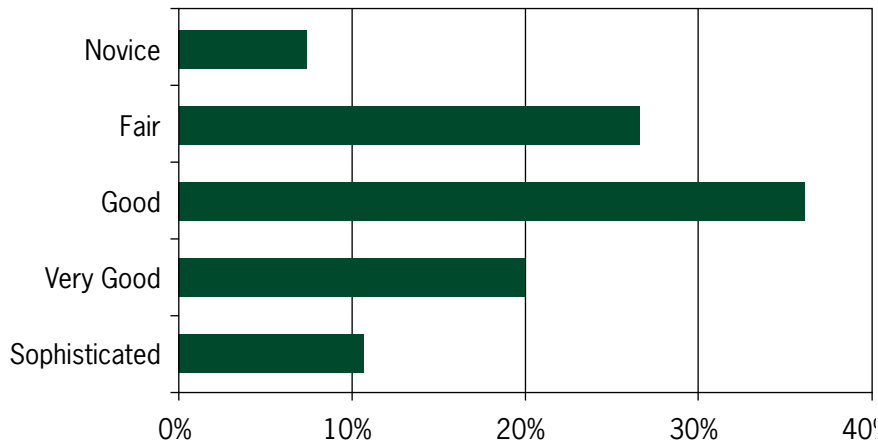
You should ask your advisor to discuss the protection in place for your portfolio — and compare it against these criteria.

¹In fact, over the long term, we don't expect clients to incur any costs associated with the primary solution we currently have in place (the structured note from Deutsche Bank that incorporates their proprietary EMERALD Index)

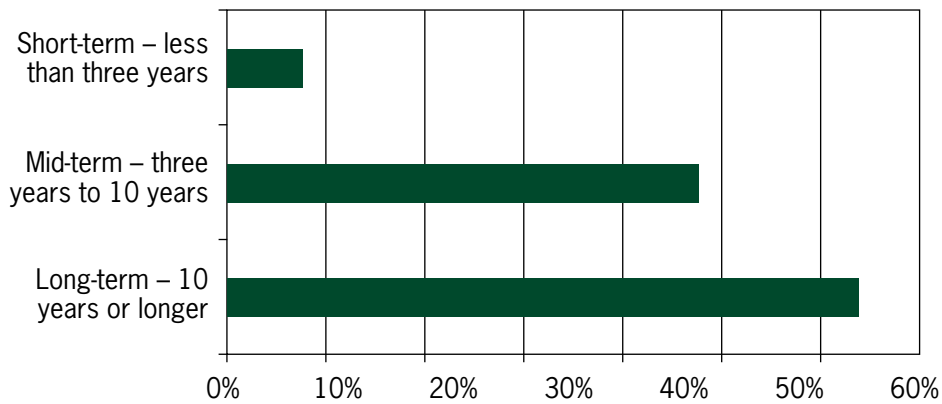
²We believe we have devised a solution (incorporating the Deutsche Bank EMERALD Index) that comes very close to meeting all three criteria, but we continue to search for, and to try to develop internally, even better solutions to protect our clients' portfolios.

Appendix

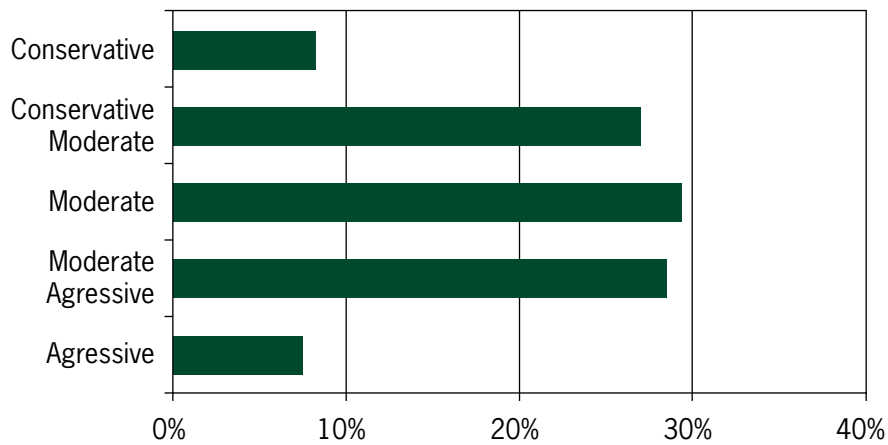
1. How would you describe your investment knowledge?



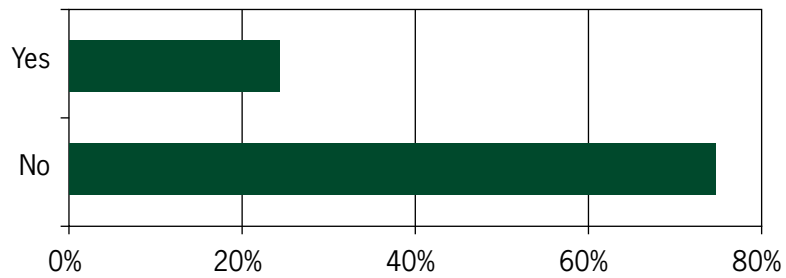
2. What is your current investment horizon?



3. How would you define yourself as an investor?

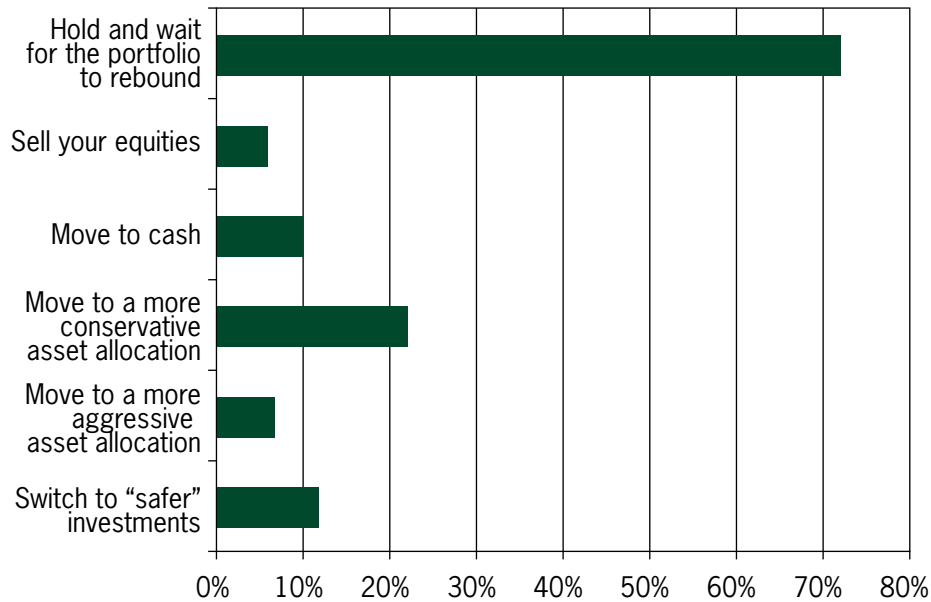


4. Did the 2008 market collapse cause you to lose faith in portfolio diversification?



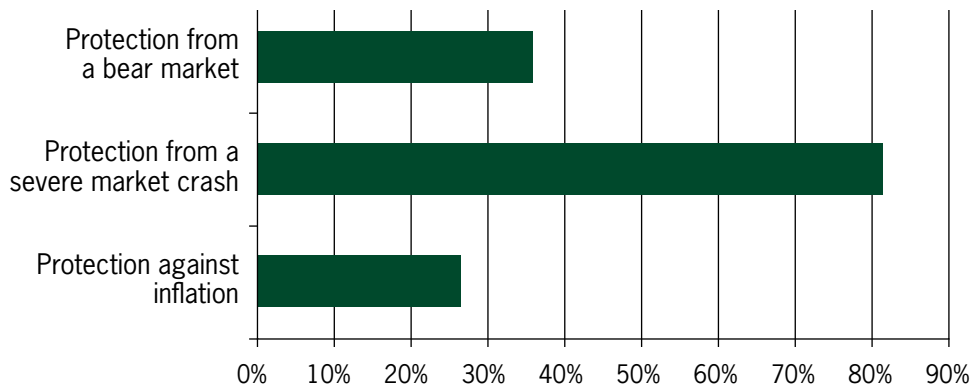
5. When the market collapsed in 2008, did you:

(Please check all that apply to you)

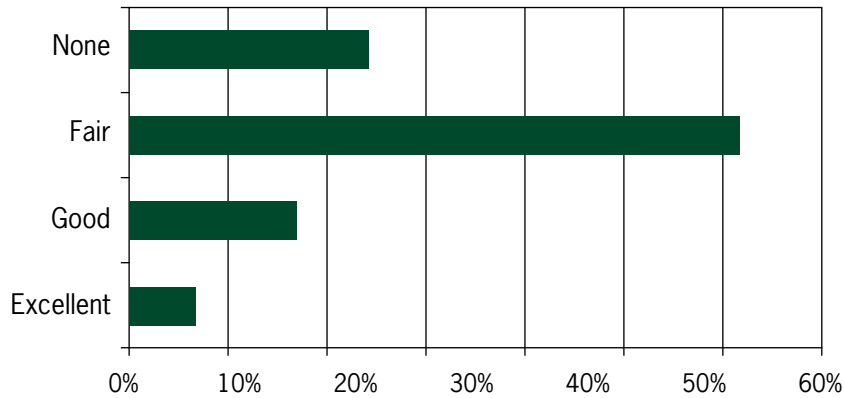


6. What does the term "portfolio protection" mean to you:

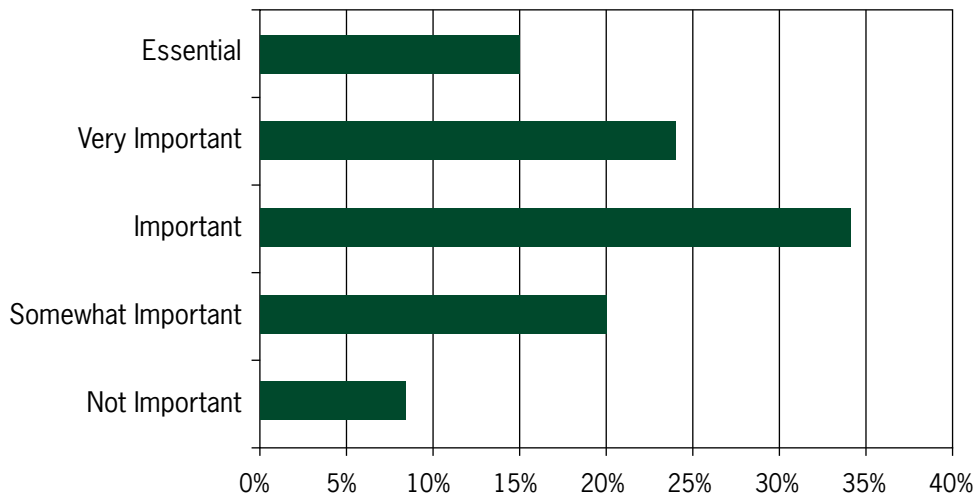
(Please check all that apply to you)



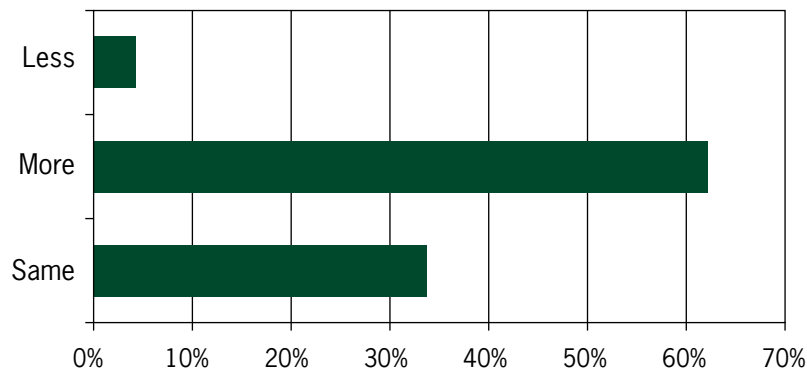
7. Which of these describes your level of knowledge of portfolio protection techniques?



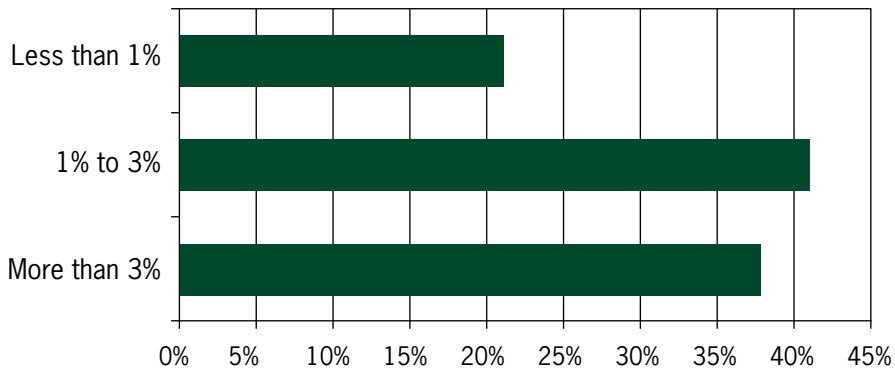
8. How important do you think it is to have portfolio protection for your investments?



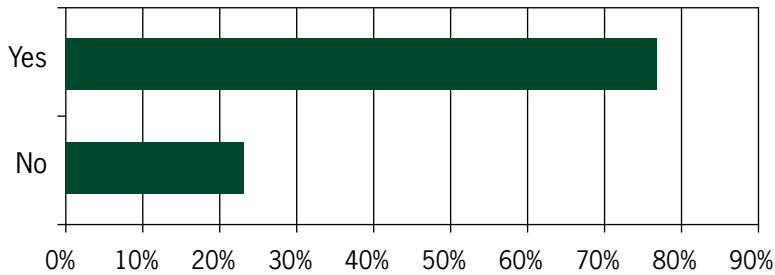
9. Have the events in the markets over the last two years made you more or less interested in portfolio protection?



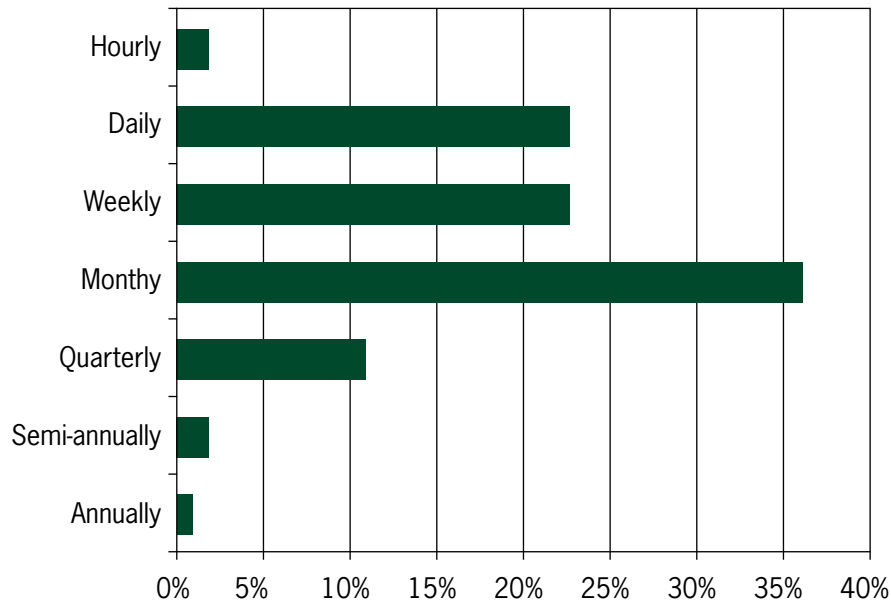
10. How much of your investable assets (total portfolio value) would you be comfortable devoting to portfolio protection?



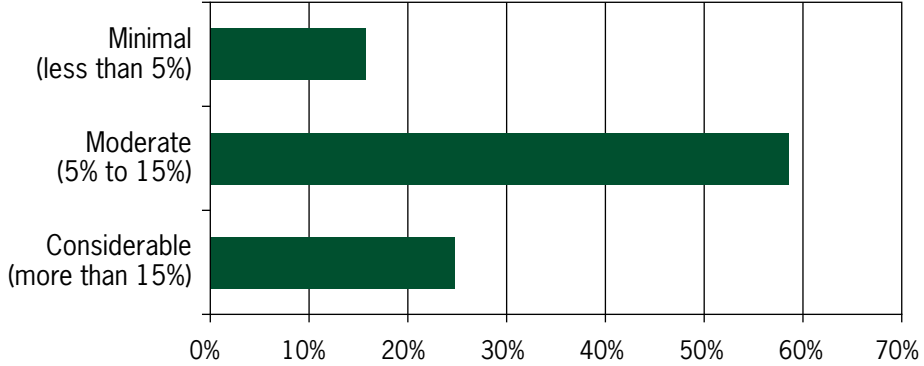
11. I would be willing to sacrifice some upside portfolio potential to defray the cost of portfolio protection



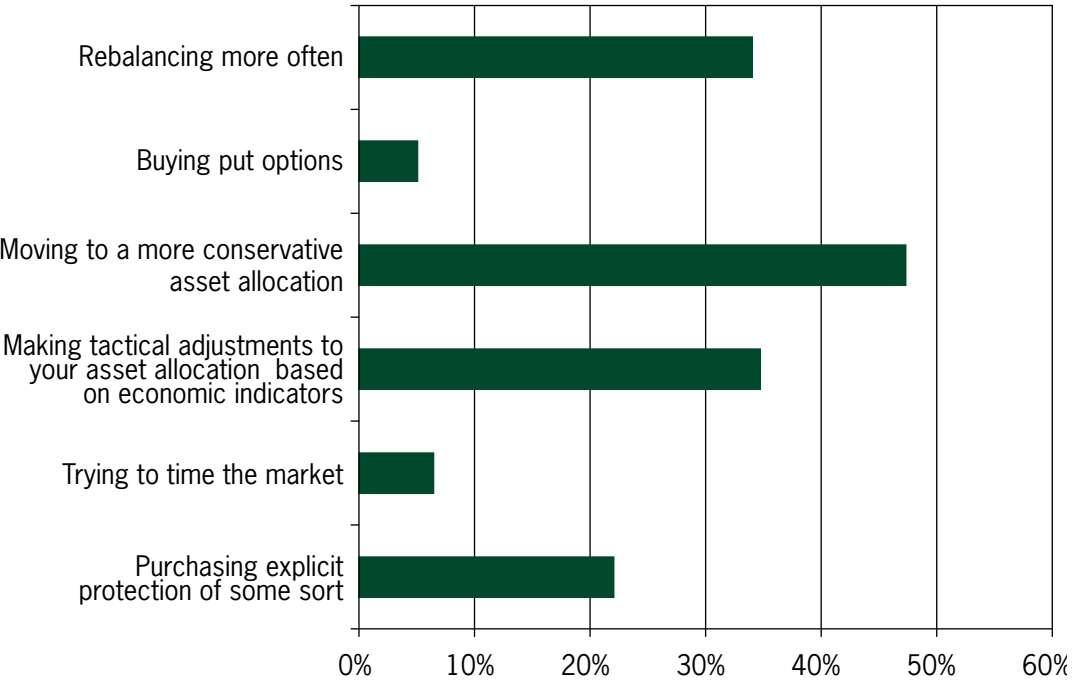
12. How often do you check the value of your portfolio?



13. How much volatility in your portfolio can you personally handle on an annual basis?



14. What are you currently using in your portfolio to minimize downside risk?
(Please check all that apply)



About the Author



Jerry A. Miccolis, CFA®, CFP®, FCAS, MAAA

Principal, Chief Investment Officer and Senior Financial Advisor
Co-author: *Asset Allocation For Dummies®* (Wiley, May 2009)

Mr. Miccolis holds the Chartered Financial Analyst® designation, is a CERTIFIED FINANCIAL PLANNER™ practitioner, and is a fellow of the Casualty Actuarial Society (FCAS). He also is a member of the American Academy of Actuaries (MAAA), the Financial Planning Association (FPA), and the New York Society of Security Analysts (NYSSA). Mr. Miccolis received a BS in Mathematics from Drexel University.

Prior to joining Brinton Eaton in 2003, Jerry had over 30 years experience in the risk management and insurance fields, including over 25 years with the international management consulting firm Towers Perrin, where he served as Principal and Global Practice Leader for the Enterprise Risk Management practice. He has chaired numerous professional committees and is a widely quoted author and speaker on the subject of strategic risk management.

Mr. Miccolis specializes in financial planning, risk management, investment research, and portfolio management.

:: About Brinton Eaton ::

Based in Madison, NJ, Brinton Eaton is an advisory firm with a long history of serving individuals and their families across multiple generations. The firm helps its clients protect, grow, administer, and ultimately transfer their legacy of wealth through a full range of integrated services, including lifetime cash flow projections, financial/tax/estate/retirement planning, investment management, charitable giving, and business succession planning. Brinton Eaton's clients tend to be corporate executives, professionals, entrepreneurs, retirees, and multi-generational families.

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Brinton Eaton is a full-service wealth management firm and is a Registered Investment Advisor with the Securities and Exchange Commission.

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CERTIFIED FINANCIAL PLANNER™ :: Chartered Financial Analyst® :: Certified Public Accountant :: Accredited Investment Fiduciary™
:: Fellow of the Casualty Actuarial Society

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