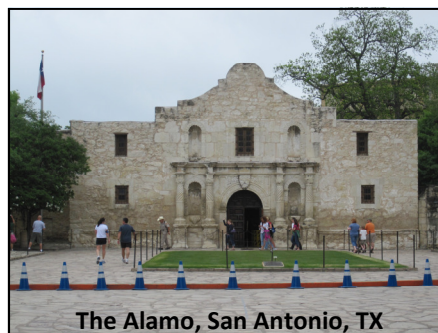


Office Calendar

May 31	Memorial Day
June 9	Bruce out of office in AM
June 17	Bruce out of office
June 28	Bruce out of office



Dynamic Portfolio Risk Control: Managing Risk in Uncertain and Turbulent Mar-

In the last ten years, investors have experienced two protracted periods of market decline that would formerly have been considered to be of “once in a generation” severity. Clearly, the world has changed. For younger investors with long-term time horizons and the ability to restore investment portfolios with additional savings, such declines are bothersome but manageable. For older investors whose ability to add to their portfolios is limited or non-existent, declines like these can be devastating.

Modern Portfolio Theory holds that the best defense against market volatility is broad diversification. Effective diversification relies on including asset classes in the portfolio that are “non-correlated” (think of some zigging while others zag). Often, in periods of market stress, asset classes that are usually non-correlated become well correlated, resulting in broad declines from which a fully invested portfolio can find no safe harbor. So it seems that the benefits of diversification are, themselves, long-term. And, as has been quipped, in the long-term, we’re all dead. Clearly we cannot rely on diversification alone as defense against the broad market declines that have come to occur too frequently for comfort.

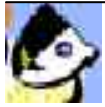
Along with many in the financial advisory profession, I have spent considerable time since the last decline searching for some way to control downside volatility. To work in a small financial planning practice, such a method would have to be easily implemented and maintained. It would have to avoid excessive trading so as to manage portfolio costs. And it couldn’t sacrifice too much of the expected returns of the portfolio. This turned out to be a relatively tall order.

A few months ago, however, I ran across an article in a trade publication about a methodology for controlling risks in portfolios taking withdrawals (“A Simple Dynamic Strategy for Portfolios Taking Withdrawals: The Case for Using a 12-Month Simple Moving Average”, by Garrison, Sera, and Cribbs, *Journal of Financial Planning*, February 2010). The dynamic model described in that article was very simplistic, investing only in the Standard & Poor’s 500 index when the model’s trigger indicated investment and in the intermediate-term US Government bonds when the model’s trigger indicated selling stocks. The authors compared the results of this portfolio to those of a variety of other strategic mixes of the same two asset classes over the period 1926-2008 which were simply rebalanced annually, concluding that the dynamically allocated portfolio was consistently superior to the strategically allocated and rebalanced portfolios. At the article’s end, the authors admitted that their research was only a “first step” and that the model needed to be expanded to test the dynamic reallocation concept with a more

Continued on page 3...

Tax Returns, Please

It’s that time of year again. As you prepare to file your 2009 income tax returns, remember to **send me a copy**. If you’re having your returns professionally prepared, ask the preparer to email PDF copies to me at bheling@helingassociates.com. Better, have them phone me and I’ll set them up with limited access to your secure web vault so they can upload them safely. And, of course, you can always mail them.



SNAKE TRAINING

This story just in from a friend who lives in the South...

I went fishing this morning but after a short time I ran out of worms. Then I saw a cottonmouth snake with a frog in his mouth. Frogs are good bass bait. Knowing the snake couldn't bite me with the frog in his mouth I grabbed him right behind the head, took the frog, and put it in my bait bucket. Now the dilemma was how to release the snake without getting bit. So, I grabbed my bottle of Jack Daniels and poured a little whiskey in the snake's mouth. His eyes rolled back, he went limp. I released him into the lake without incident and carried on fishing using the frog.

A little later, I felt a nudge on my foot. There was that same snake with two frogs in his mouth.

Life is good in the South.

RETIREE TO-DO LIST

His wife asked "Watcha doin' today?"

He said, "Nothing."

She said, "That's what you did yesterday."

He said, "I didn't finish."

RETIREE MEDICAL PROBLEM

He went to the doctor with fluid on his knee.

The doctor said, "You're not aiming straight."

AN OLD SEA STORY

(WITH POSSIBLE POLITICAL OVERTONES)

There's an old sea story in the Navy about a ship's Captain who inspected his sailors, and afterward told the Chief Boatswain that his men smelled bad. The Captain suggested perhaps it would help if the sailors would change underwear occasionally.

The Chief responded, "Aye, aye sir, I'll see to it immediately!"

The Chief went straight to the sailors berth deck and announced, "The Captain thinks you guys smell bad and wants you to change your underwear." He continued, "Pittman, you change with Jones, McCarthy, you change with Witkowski, and Brown, you change with Schultz. Now GET TO IT!"

THE MORAL OF THE STORY...

Someone may come along and promise "change", but don't count on things smelling any better afterward.

"DAVID" TO RETURN TO ITALY

A bit of cultural news for a change...

After a two year loan to the United States, Michelangelo's David is being returned to Italy. The photos below were taken before David's arrival and last week.

Two Years Ago



Last Week



David's proud sponsors during his visit in the States were



CAUTION: FAILURE TO ENGAGE BRAIN PRIOR TO MOUTH MAY BE HAZARDOUS TO HEALTH

A husband walked into Victoria's Secret to purchase a sheer negligee for his wife. He was shown several possibilities that ranged from \$250 to \$500 in price -- the more sheer, the higher the price. Naturally, he opted for the most sheer item, pays the \$500, and took it home. He presented it to his wife and asked her to go upstairs, put it on, and model it for him.

Upstairs the wife thought (she was no dummy), 'I have an idea. It's so sheer that it might as well be nothing.

I won't put it on, I'll do the modeling naked, return it tomorrow, and keep the \$500 refund for myself.'

She appeared naked on the balcony and struck a pose.

The husband said, 'Good Grief! You'd think for \$500, they'd at least iron it!'

He never heard the shot.....

Funeral on Thursday at Noon.

Dynamic Portfolio Risk Control *(continued from page 1)*

broadly diversified portfolio. As the idea seemed to meet the requirements I had identified for a workable risk management strategy, I undertook to extend the research to examine the results.

Accordingly, I created portfolios that incorporated many more asset classes and categories (intermediate bonds, high yield bonds, foreign bonds, domestic stocks in four different size categories, foreign stocks of both developed and emerging markets, real estate and commodities). Because a number of these asset categories have limited histories, I was only able to test the period from 1989 through 2009, so my tests lack something in sample size. But this time frame includes several periods of extreme market performance, both positive and negative, so I believe this study to be informative, if not conclusive. Had the conclusions reached differed in some significant way from those reached by Garrison, Sera and Cribbs, I might have had some cause for concern. But the results were remarkably similar.

In the model I designed, similar in approach to that in the article, each price of each asset category was compared at the beginning of each month to the average of the previous 12 month-end prices for the category. If the current price was higher than the average, the prior month's commitment was maintained or the position restored (if there was no investment in the class the prior month); if not, the commitment for the class/category was diverted to intermediate bonds. As each category was evaluated independently, moves into and out of asset classes (containing multiple categories) tended to be more gradual than in the published article with only two classes.

In most cases, this multi-class/category dynamic approach limited portfolio declines when it mattered most... during serious declines. It should be noted that the strategy also limited portfolio gains during market advances, most likely because significant gains are often made off market bottoms when the dynamic portfolio would likely still be invested in intermediate bonds. The net effect, however, was radically reduced volatility in all portfolios I examined and, in almost all cases, higher long-term portfolio returns as a result of the reduced variability of returns. The following examples illustrate the benefits of this approach. In Table 1 below, for each of the three portfolios illustrated, the first column shows

the portfolio's strategic allocation while the second shows the average allocation over the period 1989-2009 after having given effect to the dynamic reallocation methodology. Beneath each column are the relevant performance statistics for both the static and dynamic portfolios, followed by an analysis of the "drawdowns" each portfolio suffered during periods of market decline. What I find somewhat ironic is that even portfolios that were intended to be 100% equity unless diverted due to the dynamic reallocation process still ended up with significant long-term average allocations (between 25% - 30%) to bonds. Thus, they were "balanced" over time although fully invested in equities when markets warranted. Note also that the declining market experience of the dynamically managed Portfolio 3 (worst drawdown = 14.3%) was considerably milder than that of the much more "conservative" statically managed Portfolio 1 (worst drawdown = 25.6%) while the compound annual return was close to double. These results can only be attributed to the being invested in growth vehicles during good markets and safer investments during periods of market turbulence. An agricultural metaphor comes to mind via two old farmer's adages... "making hay while the sun shines" and "taking shelter from the storm".

Clearly there is much more research that could be done into dynamic portfolios. For example, does managing a portfolio in this fashion permit one to comfortably withdraw more without endangering the portfolio's ability to last throughout life? One would presume it would, but how much of an increase could be justified? But, under the principal that the "perfect" shouldn't become the enemy of the "good", I don't intend to pursue all the research I could before implementing this concept in client portfolios. This change, will, however, require a new investment policy statement (IPS) for everyone who elects to use it (and, frankly, I believe it to be appropriate for all HA clients) and so my attention will next be turned to designing a new IPS form that adequately describes this portfolio management strategy. To more fully communicate how the methodology will work, I'll also be putting together a client seminar in the coming months. Please be alert to the announcement and try your best to attend.

Dynamic Portfolio Risk Control *(continued from page 3)*

As always, I take my role as your trusted advisor very seriously. I have always been in search of the “better mousetrap” and I sincerely believe that I’m onto something with this concept... a way to dynamically manage portfolio risk over time in a fashion that is consistent with a small financial planning practice using investment vehicles that are commonly available and affordable. I hope you’ll agree.

Table 1: Comparison of Static vs Dynamic Management of Three Portfolios

	Portfolio 1		Portfolio 2		Portfolio 3	
Portfolio Allocation	Static	Dynamic	Static	Dynamic	Static	Dynamic
Intermediate bonds	20%	40%		27%		27%
High-yield bonds	20%	15%	10%	6%		0%
Foreign bonds	20%	12%	10%	5%		0%
Total bonds	60%	67%	20%	38%	0%	27%
US LargeCap stocks	15%	17%	20%	17%	20%	16%
US MidCap stocks	5%	6%	15%	14%	20%	18%
US SmallCap stocks	0%	0%	10%	6%	10%	5%
US MicroCap stocks	0%	0%	5%	5%	10%	8%
Foreign stocks (developed mkts)	10%	6%	15%	7%	20%	9%
Foreign stocks (emerging mkts)	0%	0%	5%	7%	10%	12%
Total stocks	30%	29%	70%	56%	90%	68%
US real estate	0%	0%	5%	4%	5%	4%
Commodities	10%	4%	5%	2%	5%	1%
Total tangibles	10%	4%	10%	6%	10%	5%
Total Portfolio	100%	100%	100%	100%	100%	100%
Portfolio Performance, 1989-2009 (241 twelve-month periods)						
Compound annual return	7.8%	9.1%	9.5%	11.9%	10.0%	12.9%
Standard deviation	8.0%	5.8%	14.0%	8.6%	16.9%	10.3%
Worst 12-month return	-23.9%	-5.8%	-40.0%	-11.6%	-47.1%	-14.3%
Best 12-month return	30.6%	28.6%	45.5%	34.2%	55.9%	40.2%
Portfolio Drawdown Analysis (from prior peak value to lowest value)						
Most severe drawdown	-25.6%	-6.8%	-45.9%	-11.6%	-54.0%	-14.3%
Longest drawdown (months)	9	7	25	12	25	12