



Building “All-Weather” Portfolios That Avoid The Black Swan

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Horizons West Capital: Leadership

❖ Steven M. MacNamara, CFA

- 25-Years Investment Management Industry Experience
- Johnson Graduate School of Management (Cornell University) - MBA
- University of Florida – BSBA (Finance)
- CFA Institute - CFA

- Investment Industry Experience (Senior Executive Level)
 - International Management Group (IMG) – Cleveland
 - Morley Fund Management International – Boston
 - Morgan Stanley Asset Management – New York
 - Bateman, Eichler, Hill, Richards – Los Angeles
 - PartnerRe Asset Management – Greenwich

Horizons West Capital Partners, LLC

- ❖ An SEC Registered Investment Advisory/Consulting Firm
- ❖ Launched In 2008 / Based In Connecticut (Fairfield County)
- ❖ HWCP Advisor Consulting Services
 - Dynamic Asset Allocation Modeling
 - Investment Manager Search/Due Diligence
 - Advisor Client/Prospect/COI Marketing Assistance
 - HWCP Emerging Manager Focus List (Initial launch Sept/Oct 2010)

Webinar Agenda

- ❖ The Black Swan

- ❖ The Five Steps In Creating An All-Weather Investment Portfolio
 - Identify / Assess The Relevant Portfolio Risk(s)
 - Isolate Full Range Of Asset Class Opportunities
 - Construct Asset Class Returns / Volatility Matrix
 - Perform Fund Manager Search / Due Diligence
 - Establish Feedback / Rebalancing Methodology

- ❖ Parting Thoughts / Q & A (via email)

The Black Swan

- ❖ “An event or occurrence that deviates far beyond what is normally expected of a situation that would seemingly be extremely difficult if not impossible to predict in advance”. (The impossible becomes real)

- ❖ Market Related Black Swans (1985 - 2010)
 - 1987 – Stock Market Crash
 - 1994 – The Fed Raises Rates (February)
 - 1997 – Asian Tiger Contagion
 - 1998 – Russia Defaults/LTCM
 - 2007 – Quantitative Hedge Fund Meltdown
 - 2008 – Weekend At Bernie’s (Chairman Bernanke)
 - 2010 – Flash Crash (May 6, 2010)



What Is NOT A Black Swan

- ❖ NASDAQ / Technology Stock Bubble (1995 – 2000)
- ❖ US Real Estate Bubble / Crisis (2002 – 2007)
 - *Fortune Magazine* (May 30, 2005)

- ❖ Who Didn't See These Crashes Coming ???



An Investment Portfolio For All Seasons

❖ Investment Portfolios Require A Balancing Act Among Elements

- Appropriate Risk Assessment
- Informed Asset Allocation
- Favorable Security Selection

❖ The Above Elements MUST Be In Congruence

- Unbalanced Portfolios Often Implode Under Stress



Portfolio Construction Complicating Factors

- ❖ Investor “Risk” Tolerance Is Typically Not Well-Defined
- ❖ Forecasting Asset Class Performance Is Exceptionally Difficult
- ❖ Too Often Fund Manager Due Diligence Is Cookie Cutter...Or Worse
- ❖ Risk/Return Mismatches Must Be Avoided
 - Early Spring 2000
 - Late Summer 2007
 - Late Winter 2009



Building All-Weather Portfolios For Clients: Step I

- ❖ Formally Adopt A Single Relevant Metric Of Portfolio Risk
 - Must Be Actual Data (Not A Forecast) Observable In Real Time / Daily
 - Metric Must Always Be Considered In The Appropriate Investor Context

- ❖ Risk Metric / V(ar) Commentary
 - **"We were seeing things that were 25-standard deviation moves, several days in a row."**
 - A downside 25-sigma event would occur materially less than once every 15 **billion** years (chances of the above happening are considered by many experts to be so minute as to be incalculable)

Building All-Weather Portfolios For Clients: Step I (cont)

- ❖ Create Manageable Number Of Portfolio Risk Profiles
- ❖ The Five HWCP Portfolio Risk Buckets

- Portfolio Designation

Volatility Target (60 Day HV)

- | | |
|-------------------|--------------------------|
| ➤ Defensive | 4.00% (- 60%) |
| ➤ Conservative | 8.00% (- 20%) |
| ➤ Balanced | 10.00% (Baseline) |
| ➤ Progressive | 12.00% (+ 20%) |
| ➤ Dynamic | 14.00% (+ 40%) |

Building All-Weather Portfolios For Clients: Step I (cont)

❖ Primary Volatility Metrics Continually Under Review

- Short-Term Intervals (Days) : 5, 10, 30, 45, 60, 90
- Long-Term Intervals : 120 Day, 180 Day, 360 Day, 162 Week

❖ Rolling Time Periods (Smoothed) Under Review

- Daily, Weekly, Bi-Weekly, Monthly, Quarterly, Annually
- 3-Year, 5-Year, 7-Year, 10-Year, 15-Year, 20-Year
- Trend Analysis To Reduce/Eliminate “False” Indicators

Building All-Weather Portfolios For Clients: Step II

- ❖ Assemble Complete Opportunity Set Of Global Asset Classes (14)
 - Global Fixed Income (6) : LT Agg, ST Agg, HY, MBS, TIPS, Cash
 - Equity-Like (2) : Commodity, Real Estate
 - Domestic Equity (3) : Small Cap, Mid Cap, Large Cap
 - International Equity (2) : Developed Market, Emerging Market
 - Hybrid/Hedged (1) : Multi-Strategy / Alternative

HWCP Portfolio Construction Process: Step III

- ❖ Forecast 12-Month Forward Asset Class Return / Volatility Matrix

- ❖ Create “Efficient Frontier” Portfolio For Each Investor Profile

- Black-Litterman Protocol (Plus HWCP Adj.)
- Monte Carlo Simulation
- Portfolio “Optimization” (LP)

- ❖ Model Output Is NOT Gospel !!!

- “Optimized” Results Still Require Fine-Tuning
- Monte Carlo/Optimization Demo

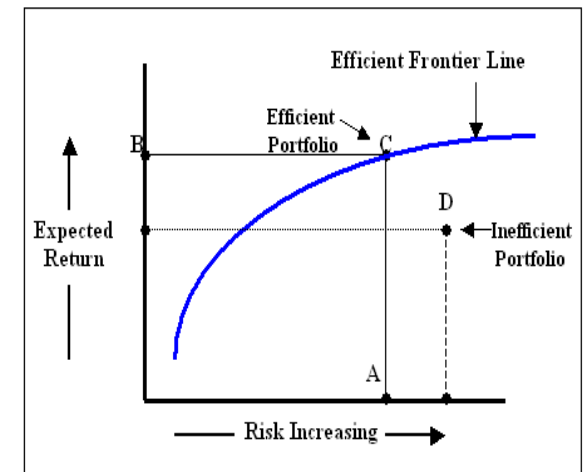


Figure 1

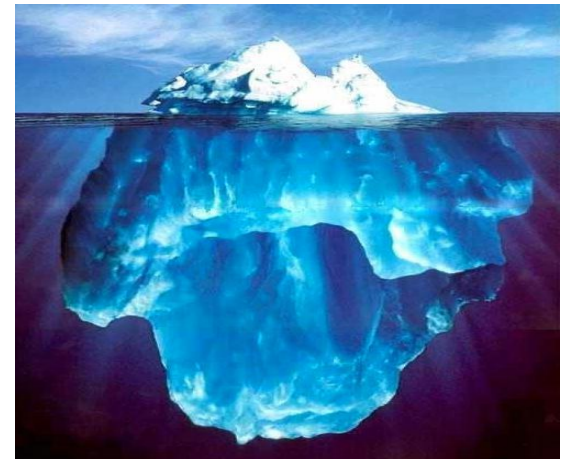
HWCP Portfolio Construction Process: Step IV

❖ Fund Manager Due Diligence (Areas Of Investigation)

- Returns-Based Analyses (10)
- Holdings-Based Analyses (8)
- Qualitative Analyses (10)

❖ HWCP Manager Selection Criteria

- Methodology
- Flexibility
- Excellence
- Relevance



HWCP Portfolio Construction Process: Step V

❖ Feedback Mechanism

- Model Assumptions / Inputs Critically Evaluated On A Daily Basis
- Attempt To Mitigate Decline In Model Signal Strength/Time Decay

❖ Model Portfolios Created To Assess HWCP Process Viability

- Multi-Level Attribution Of All Model Portfolios Is Performed Daily
- Portfolio Rebalancing Is Formally Undertaken On A Quarterly Basis
- Model Portfolio Performance Is Tracked Daily / Published Weekly

Parting Thoughts

- ❖ Never Own Overpriced Assets Regardless Of Your “Risk” Tolerance
- ❖ Investing Is A Losers Game So You Must Always Act Accordingly
- ❖ Never Try To Manage Portfolio Risk By Attempting To Predict It
- ❖ Don’t Lose Sight Of The 99% Solution When Selecting Funds
- ❖ The Arithmetic Of Losses Is Not On Your Side
- ❖ “Nobody Knows Anything”





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