

# INVESTMENT MANAGEMENT IN TURBULENT MARKETS

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# Three Unlikely Wise Men of Investing

- Bob Dole
- Henny Youngman
- Clint Eastwood (Dirty Harry)

# “Dirty Harry Defense”

- It is important to know what you know, know what you don't know and know what is unknowable
- Broad diversification across all asset classes and diversification within asset classes is the key to surviving turbulent markets

# Risk Tolerance and Asset Allocation

- Risk tolerance is a function of individual attitude toward risk, knowledge of investment alternatives, investment time horizon, and overall wealth.
- Assessment of risk tolerance leads to target asset allocation

# Risk Tolerance Questionnaire

- 1. Earning a high long-term total return that will allow my capital to grow faster than the inflation rate is one of my most important investment objectives.
- 2. I would like an investment that provides me with an opportunity to defer taxation of capital gains to future years.
- 3. I do not require a high level of current income from my investments.

# Risk Tolerance Questionnaire

- 4. I am willing to tolerate some sharp down swings in the return on my investments in order to seek a potentially higher return than would normally be expected from more stable investments.
- 5. I am willing to risk a short-term loss in return for a potentially higher long-run rate of return.
- 6. I am financially able to accept a low level of liquidity in my investment portfolio.

# Risk Tolerance Questionnaire

- Over what period of time do you expect to remain invested in this portfolio?
- Three years or less \_\_\_\_\_  
– (short term horizon)
- Four to seven years \_\_\_\_\_  
– (intermediate term horizon)
- More than seven years \_\_\_\_\_  
– (long term horizon)

# Short Time Horizon

Short Time Horizon	RT1	RT2	RT3	RT4
Cash and Money Market Funds	40.0%	30.0%	20.0%	10.0%
Treasury Bonds/Bond Funds	40.0%	30.0%	30.0%	20.0%
Corporate Bonds/Bond Funds	20.0%	30.0%	30.0%	40.0%
International Bond Funds	0.0%	0.0%	0.0%	0.0%
Index Fund	0.0%	10.0%	10.0%	10.0%
Large Cap Value Funds/Stocks	0.0%	0.0%	5.0%	5.0%
Large Cap Growth Funds/Stocks	0.0%	0.0%	0.0%	0.0%
Mid/Small Growth Funds/Stocks	0.0%	0.0%	0.0%	0.0%
Mid/Small Value Funds/Stocks	0.0%	0.0%	0.0%	5.0%
International Stock Funds	0.0%	0.0%	0.0%	5.0%
Real Estate Funds	0.0%	0.0%	5.0%	5.0%

# Intermediate Time Horizon

Intermediate Time Horizon	RT1	RT2	RT3	RT4
Cash and Money Market Funds	5.0%	5.0%	5.0%	5.0%
Treasury Bonds/Bond Funds	60.0%	35.0%	20.0%	10.0%
Corporate Bonds/Bond Funds	15.0%	15.0%	15.0%	10.0%
International Bond Funds	0.0%	5.0%	5.0%	5.0%
Index Fund	10.0%	15.0%	15.0%	20.0%
Large Cap Value Funds/Stocks	5.0%	5.0%	10.0%	10.0%
Large Cap Growth Funds/Stocks	5.0%	5.0%	5.0%	10.0%
Mid/Small Growth Funds/Stocks	0.0%	0.0%	5.0%	5.0%
Mid/Small Value Funds/Stocks	0.0%	5.0%	5.0%	5.0%
International Stock Funds	0.0%	5.0%	10.0%	10.0%
Real Estate Funds	0.0%	5.0%	5.0%	10.0%

# Long Time Horizon

Long Time Horizon	RT1	RT2	RT3	RT4
Cash and Money Market Funds	5.0%	5.0%	3.0%	2.0%
Treasury Bonds/Bond Funds	30.0%	20.0%	12.0%	0.0%
Corporate Bonds/Bond Funds	15.0%	10.0%	10.0%	4.0%
International Bond Funds	0.0%	5.0%	5.0%	4.0%
Index Fund	20.0%	20.0%	20.0%	23.0%
Large Cap Value Funds/Stocks	10.0%	10.0%	5.0%	5.0%
Large Cap Growth Funds/Stocks	5.0%	5.0%	5.0%	5.0%
Mid/Small Growth Funds/Stocks	5.0%	5.0%	10.0%	15.0%
Mid/Small Value Funds/Stocks	5.0%	5.0%	10.0%	15.0%
International Stock Funds	0.0%	5.0%	10.0%	15.0%
Real Estate Funds	5.0%	10.0%	10.0%	12.0%

# MODEL PORTFOLIOS

	<b>Conservative</b>	<b>Growth &amp; Income</b>	<b>Aggressive Growth</b>
<b>Treasury Bills</b>	<b>5.0%</b>	<b>3.0%</b>	<b>3.0%</b>
<b>Lehman Bond Aggregate</b>	<b>40.0%</b>	<b>32.0%</b>	<b>17.0%</b>
<b>S&amp;P 500</b>	<b>35.0%</b>	<b>38.0%</b>	<b>45.0%</b>
<b>EAFE Index</b>	<b>10.0%</b>	<b>15.0%</b>	<b>21.0%</b>
<b>Wilshire REIT</b>	<b>10.0%</b>	<b>12.0%</b>	<b>14.0%</b>
<b>Total</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>

# HISTORICAL RETURNS

Year	2006	2005	2004	2003	2002
Treasury Bills	5.1	3.3	1.4	1.1	1.7
Lehman Brothers Aggregate Bond Index	4.3	2.4	4.4	4.1	10.3
Standard And Poor 500 Index	15.8	4.9	10.9	28.7	-22.1
EAFE Index (Europe, Australia, Far East)	26.4	13.6	20.3	38.6	-15.9
Wilshire REIT Index	36.1	14.0	33.8	36.1	3.6
Year	2001	2000	1999	1998	1997
Treasury Bills	3.7	6.3	4.9	5.0	5.3
Lehman Brothers Aggregate Bond Index	8.4	11.6	-0.8	8.7	9.7
Standard And Poor 500 Index	-11.9	-9.1	21.0	28.6	33.4
EAFE Index (Europe, Australia, Far East)	-21.4	-14.2	27.0	20.0	1.8
Wilshire REIT Index	12.4	31.0	-2.6	-17.0	19.7

# MARKET INDEX RETURNS

<b>Return Summary</b>	<b>3 YEARS 2004-06</b>	<b>5 YEARS 2002-06</b>	<b>10 YEARS 1997-06</b>
<b>Treasury Bills</b>	<b>3.3%</b>	<b>2.5%</b>	<b>3.8%</b>
<b>Lehman Bond Aggregate</b>	<b>3.7%</b>	<b>5.1%</b>	<b>6.2%</b>
<b>S&amp;P 500</b>	<b>10.4%</b>	<b>6.2%</b>	<b>8.4%</b>
<b>EAFE Index</b>	<b>20.0%</b>	<b>15.0%</b>	<b>7.7%</b>
<b>Wilshire REIT</b>	<b>27.6%</b>	<b>24.0%</b>	<b>15.4%</b>

# PORTFOLIO RETURNS

<b>Model Portfolio</b>	<b>3 YEARS</b>	<b>5 YEARS</b>	<b>10 YEARS</b>
<b>Returns</b>	<b>2004-06</b>	<b>2002-06</b>	<b>1997-06</b>
<b>Conservative</b>	<b>10.7%</b>	<b>8.7%</b>	<b>8.6%</b>
<b>Growth &amp; Income</b>	<b>11.6%</b>	<b>9.6%</b>	<b>9.0%</b>
<b>Aggressive Growth</b>	<b>13.5%</b>	<b>10.5%</b>	<b>9.4%</b>

# Asset Allocation Results

- The three sample allocations, in order of increasing risk, are labeled "Conservative," "Growth and Income," and "Aggressive Growth." None of these portfolios are intended as recommendations for actual investments: each is meant simply to offer an illustration of past attained returns that could have been earned in each of these asset class combinations. Treasury bills are guaranteed by the U.S. government and if held to maturity may offer both a fixed rate of return and a fixed principal. An actual portfolio for any specific account must be constructed to meet specific risk/reward preferences of a specific client. These asset combinations do not reflect the deduction of advisory fees and other material expenses a client might have paid. Management advisory fees are charged at a rate beginning at nine-tenths of one percent of assets under management, declining after the account size reaches \$500,000 and subject to an annual minimum fee of \$2,000. Management and transaction fees can significantly impact investment performance. Model allocations report past performance of the asset classes, assuming reinvestment of all income and capital gains dividends. These results are "backtested" in that the investment returns presented show historical data. Such results do not reflect actual trading and they may not reflect the impact that material economic and market factors might have had on the advisor's decision-making if the advisor were actually managing clients' money. Share prices, yields and returns will vary, and you may have a gain or loss when shares are sold. Furthermore, past results do not predict future results and there is no implied or express guarantee that future results will mirror past results or result in gains rather than losses. Backtested performance data are subject to a large number of factors, including historical bias, limited database quality, software bugs and potential misuse of optimization, that make it particularly hazardous to believe that the results of a backtest can be duplicated prospectively in the real world. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown for the model portfolios.

# Mutual Fund Performance Persistence

- Does performance persist?
- If no, can there be any justification for using mutual fund past performance as a criterion for selecting mutual funds?

# Published Research

- Eight major performance persistence studies published 1992 – 2004
- Five common “lessons learned” emerge from these studies

# PERFORMANCE PERSISTENCE SUMMARY

“Lessons learned” from persistence  
research

- 1. Past performance counts, especially poor past performance. Poor past performance is a strong predictor of future poor performance.

# PERSISTENCE SUMMARY

- 2. Performance persistence relative to same-category funds is stronger than persistence relative to overall market.
  - e.g., “category beaters” more likely to continue above-category than above broad market

# PERSISTENCE SUMMARY

- 3. Short-term persistence is much stronger than long-term persistence.
- 4. Morningstar (within category) 3 to 5 star funds provide good candidates for investing and 1 to 2 stars good funds to avoid

# PERSISTENCE SUMMARY

- 5. Even funds (and independent managers) with excellent long-term records will not be in the top quartile (or top half) every year
  - one bad year is not sufficient reason to sell

# MORNINGSTAR RATINGS

Blake and Morey: Morningstar ratings as predictors:

Low MS ratings are reliable predictors of poor future performance

Weak statistical evidence that highest rated funds outperform next-to-highest and median funds

MS ratings slightly better than alternatives.

# Mutual Fund Performance vs. Index

Morningstar Fund Investor, Nov 1999: %  
of active funds that beat comparable index

Large Cap Growth/Blend/Value 10%

Mid-Cap Blend 30%

Small Growth 91%

Small Blend 54%

Small Value 81%

# PERFORMANCE vs. INDEX

- From Morningstar Fund Investor, Four common characteristics of successful active equity funds:

Low turnover: turnover less than half category average

Low expenses: Most index-beaters have expense well below category average

# Morningstar Fund Investor

Sector focus: two largest sectors typically total at least 60% of assets

Concentrated portfolio: at least 40% in top ten holdings common. For small-cap funds, rule of thumb 30% or more

# DSA Investment Strategy

1. Establish risk tolerance profile
2. Fixed income: general preference for laddered corporates/Treasuries but some special purpose bond funds
  - International
  - Convertible (market neutral)

# DSA Investment Strategy

## 3. Domestic Stocks

General preference for funds vs. stocks

Normally index 40% to 50% of large  
cap commitment

Supplement large cap index with large  
and mid/small value and growth  
active funds

# DSA Investment Strategy

## 4. International Stocks

Strong preference for funds over  
individual stocks

Never index

Value tilt

# DSA Investment Strategy

## 5. Real Estate Investment Trusts

Mutual funds only

All actively managed

Beginning 2005, diversifying into  
International REITS (approximately 1/3)

# Droms Strauss Advisors

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