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The Athletic Portfolio

By Suzanne McGee

September 1, 2009

Back when he was in his thirties, Hans Olsen, chief investment officer of private client services at JP Morgan's private banking division, decided to take up Asian-style boxing. "I needed to do something different to keep my mind clear and focused on the job," he says. Training under a master kickboxer, Olsen became a mid-level fighter and—to his surprise—picked up some thoughts about how to manage clients' investment portfolios during tumultuous times like these. When the old rules-buying-and-holding, diversifying in order to reduce risk—seemed to no longer apply, the lessons learned during intensive athletic training kicked in. "A good athlete is strong, has endurance, and skill and technical proficiency at the core," Olsen explains. "In this environment, a good portfolio is one that rides out storms and takes advantage of opportunities—one that demonstrates just that same kind of strength, flexibility and endurance."

Welcome to the era of the athletic portfolio, the kind that's able to deliver maximum performance with grace, efficiency, power and a minimum of drama. Top athletes like Derek Jeter on the baseball field, Shaquille O'Neal on the basketball court or Michael Phelps in the pool are able to deliver that extra bit of edge and post topnotch results after a lot of hard work and specialized training. Now some advisors are trying to find ways to make the portfolios they manage work harder and smarter, in an environment where every fraction of a percentage point is more important than ever before. "Being tactical is the equivalent of being technically proficient as an athlete,"

Olsen says. "You need to be aware of everything that you can do, each move that is possible and what it takes to execute that."

Despite the springtime rally, there is still a chance that over the coming decade financial markets may be less generous to investors than in the past. Olsen believes that being prepared for the future to look more like the 1970s and 1980s is prudent. "In that kind of environment, what really counts is an advisor's or manager's ability to tease out extra performance where performance, overall, isn't very forthcoming."

As advisors know all too well, today many clients have less tolerance for risk than they did a year or two ago. At the same time, the losses that caused

that risk aversion mean that every bit of performance an advisor can capture is more crucial to their ability to achieve their clients' long-term financial objectives. No ethical advisor will push a client to take more risk than is appropriate, so the battle to earn additional returns and recoup some of those losses comes down to savvy investment tactics.

Some of that is about taking advantage of the mistakes of others—such as those investors who were forced to sell in order to meet margin calls or fund redemptions at the height of the market panic, and ended up selling their best assets at a discount. To others, running an athletic portfolio means looking at new strategies and products, sometimes esoteric ones that may range from private equity fund partnerships sold on the secondary market (for the wealthiest investors) to the new breed of leveraged exchange-traded funds. (While these are

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available to even the smallest retail investors, Olsen and others point out that leveraged ETFs may not always deliver exactly the kinds of returns investors expect because of the way the leverage alters the relationship between the index and the investment; Massachusetts regulators are also probing the products.)

POSTMODERN PORTFOLIO THEORY

"The kind of investment strategy that works in a bull market-just diversify the portfolio and then be complacent when it generates returns-isn't a good approach to today's more bearish economic environment, and the volatile and unpredictable financial markets," argues Kirk Chisolm, a wealth manager with NUA Advisors in Portland, Maine, who oversees about \$20 million in assets. "The rules today are different; buying-and-holding for the long-term is now what looks risky. Instead, you have to be creative and thoughtful, and look for ways on the margin that you can get the portfolios to generate even a bit of extra return. And then you need to protect every bit of what your clients earn."

The events of 2008 left many financial planners and advisors-Chisolm among them-with less patience for long-term, relatively inflexible strategies such as buying-and-holding throughout market dips and boom periods alike. That, they argue, is akin to an athlete just focusing on strength training, to the exclusion of speed or flexibility.

Diversifying among value and growth investments is just one lynchpin of modern portfolio theory that some advisors and investors now look at with enhanced skepticism. Michael Breen, senior analyst at Morningstar in Chicago, can understand why. "I have never before seen the same degree of overlap between large-cap growth and value funds," Breen says. Veteran value managers snap up growth stocks like Apple, while both growth and value managers buy energy stocks.

"There's a tremendous dispersion in returns within a style category," he notes. Fund managers who outperform, Breen says, are those best able to identify winners, like value manager John Rogers. His Ariel Fund bought stock in publishing company Gannett near its 52-week low of \$1.85; in August it traded closer to \$8 a share.

THE OPPORTUNISTIC EDGE

The question advisors grapple with is how to replicate that kind of feat across the client portfolios they manage. How can they be opportunistic? What are the best strategies and tactics that might transform an ordinary portfolio into one that's really athletic and able to generate even a few basis points of extra return? "You have to be constantly looking out for ways to make a portfolio work harder all the time," argues Maury Fertig, chief investment officer of Relative Value Partners, a Northbrook, Ill.-based firm that manages some \$360 million in client assets.

Over the long term, Fertig believes that stocks as an asset class may well continue to demonstrate outperformance; in the shorter term, however, they also seem to contain a lot of risk. "Some of the low-hanging fruit out there, the obvious bargains, have already been picked," he says. With the landscape littered with value traps and volatility, Fertig, at least, believes convertible securities are the best option, offering an alluring combination of income and potential capital gains. "They have half the volatility of equities, and they give you most of the characteristics of the equity market," he says. "So you get the stock exposure, but in a less risky way. That kind of combination has a role in a harder-working portfolio."

Tactical asset allocation is probably one of the most time-tested strategies that advisors can deploy in an effort to coax client portfolios into turning in a stronger performance. The strategy still gets short shrift from many veteran market pundits and financial planners, who argue that it's almost impossible to make the right decisions-both when to buy and when to sell-at the right times consistently. Nonetheless, some advisors are taking a fresh look at TAA as a way to capture a bit of extra profit from a volatile market, one that switches direction frequently or where different asset categories or industry groups rotate in and out of favor, or in directionless markets. "We've had both of those types of markets for most of this year," says Walter Gerasimowicz, chairman and CEO of Meditron Asset Management, a New York-based advisory firm with \$1.1 billion in client assets.

In Gerasimowicz's view, giving an athletic portfolio a full workout means using some TAA tools. "Tactical decisions may only explain 5% of returns, according to all the academic studies, but they are very important in determining how much a portfolio outperforms within each part of an asset allocation," he explains. There's still value in having an overall strategic asset allocation, he adds, but when it comes to what happens in each "sleeve"-the actual stocks, bonds, commodities, managed futures or currencies-advisors must be willing to grab short-term opportunities and squeeze every fraction of return out of them.

SELECTING PEAK PERFORMERS

Financial advisors trying to ensure their clients' assets are delivering peak performance need to pay attention to which asset classes they include in those portfolios in the first place. "You need to have a sleeve of alternative investments in client portfolios-funds that offer uncorrelated and absolute returns," argues Tim Bearden, managing partner of Stonebridge Financial Partners. The fee-based planning firm is based in the Michigan community of Bingham Farms and manages about \$200 million in client assets, of which Bearden says about 20% is invested in commodity funds, market-neutral strategies or managed futures funds. "I don't believe in market timing, but right now, traditional asset allocation, where you pick a mix and sit on it and wait, isn't working well either," Bearden says. "We're trying to use common sense and be more nimble."

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One set of products that fits that bill, Bearden notes, is the managed futures funds managed by Ken Steben of Steben & Co. He's also intrigued by a principal-protected three-year note offered by DWS, a division of Deutsche Bank. "It's basically a bearish bet on the dollar. You get your money back if the dollar stays flat or rises in value, but if it declines (against a basket of currencies from Brazil, Russia, India and China), you get 125% of the spread," Bearden explains. To him, this is an attractive alternative to keeping money in cash for his clients. "It's about making the cash part of a portfolio work harder—you can't overlook any part of your asset allocation if you're trying to make the portfolio perform to its maximum potential."

A whole host of new products have been launched to appeal to advisors trying to make client portfolios more athletic. Andrew Lo, a noted MIT professor, has long advised on hedge fund strategies; now he and his staff at AlphaSimplex Group manage the just-launched Natixis ASG Global Alternatives fund, a hedge fund-like product aimed squarely at the retail market. (The minimum investment is \$2,500.) The fund uses what Lo calls "hedge fund beta replication" to identify and mimic the most common investment bets made by an assortment of large hedge funds, and it has outperformed the S&P 500 Index in the nine months after its launch last September. Meanwhile, Van Eck Global has also announced plans to introduce an open-end fund, the Van Eck Multi-Manager Alternatives Fund, which will put money to work in funds using hedge fund-like strategies. In the universe of exchange-traded funds, which are now standard tools used by many advisors, leveraged ETFs are making a big, if controversial splash as a way to try to capture a bit of extra return. The goal of these products is to return a multiple of the profit of the return on an index or basket of securities, using options and other derivative products to magnify gains that a plain-vanilla ETF would capture.

"Like a lot of advisors, we're cautious about what kinds of products we'll use, especially when something is the new, new thing or rather esoteric," says Todd Millay, managing director of Boston-based Choate Investment Advisors. ETFs are great, he says, but leveraged ETFs can be harder to use. "When you introduce leverage into the picture, you end up with tracking error; you aren't necessarily getting what you think you're getting, especially over a longer period of time," Millay observes. Massachusetts securities regulators have begun to scrutinize the sales practices of some firms that market leveraged ETFs to the public, due to concerns about the nature of returns and what the regulators say are the potential for significant transaction costs. In the wake of that probe, some advisory firms, including Edward D. Jones & Co. and LPL Investment Holdings have banned their advisors from selling the products to clients. Other firms such as Morgan Stanley Smith Barney have set restrictions on the sales of these products.

Although many advisors are wary of the more esoteric and complex new products and strategies being aggressively marketed now, they are still willing to incorporate a greater array of asset classes and products in client portfolios. Commodities are no longer the exclusive domain of speculators and gold bugs; hedge funds are relatively mainstream and structured notes are commonly used in a bid to enhance portfolio returns. Along with the latter, option strategies, such as covered calls, are likely to become far more common as advisors try to squeeze an extra few basis points in performance out of the assets they manage.

"When you start looking at the whole array of investment alternatives from a tactical perspective, you start seeing it in a different way," says Chisolm of NUA Advisors, who is particularly interested in options strategies. When the VIX index, the mostly widely used measure of stock market volatility, is at 30, covered call option strategies of various kinds make sense, he says. "But if it's under 30, look at buying long-term calls, such as LEAP index options. You put up a minimal amount of money, and you get the same return that you would from buying the stocks." Fertig shares Chisolm's affection for option strategies and favors Nuveen funds specializing in covered calls, including the Nuveen Premium Opportunities Fund.

Some of the oldest products around can also be used to squeeze an extra bit of return from a portfolio. Closed-end mutual funds were the bee's knees in the days before the Great Depression. Now even as prophets of doom compare the current plight with that era, some advisors are devising new ways to use them. Traditionally, these funds trade at a discount to their net asset value, meaning that it's possible to pick up \$1 worth of assets for, say, 90 cents. As panic swept through financial markets last year, those valuation gaps widened even more. That created a short-term opportunity to make a bit of extra return simply by buying at those wider spreads and waiting for them to contract. But some managers are going further still. At Western Investment, activist manager Art Lipson has been pushing to unlock that discount altogether by converting funds like Tri-Continental Corp. into more conventional open-ended funds, or simply through a tender offer. Advisors note that that can be trickier for a financial planner to do directly. "It takes time and can incur a lot of legal fees, so finding a manager who does this is probably the best strategy," Fertig says.

Traditional strategies may also pay off more than advisors may expect. The Gabelli Global Deal Fund was one of the few stock mutual funds that came within a whisker of generating a positive return for 2008. (Only one fund wound up in the plus column for the year.) That's because rather than making directional bets on one of the century's most difficult markets, manager Mario Gabelli was using merger arbitrage, playing the difference in prices between acquirer and target in an announced merger deal.

"It's hard for an advisor or an investor to play in this area directly, because deals can blow up so easily," Fertig says. With fewer hedge funds participating in the merger arbitration market, it's easier for the remaining managers in this space to capture returns, he argues. "Arbitrage is one of those areas where, if you know how to trade and know the deal world, you can earn a bit of extra return around the margins."

PUSHING THE ENVELOPE

Even seemingly toxic asset classes have an allure when it comes to making a portfolio work harder to earn its keep. Bearden, for one, is a fan of real estate—at least in the form of nonpublic real estate investment trusts. These, he observes, are a relatively stable part of that out-of-favor market, which are able to generate a steady (and relatively high) yield. For instance, some of Bearden's clients now hold positions in a specialized healthcare REIT (nonpublic), whose net asset value has been steady and that's generating a dividend yield of 7%. "And that dividend, in contrast to what's happening in the stock market, is safe," Bearden insists. At JP Morgan, Olsen favors commercial mortgage-backed securities.

Some advisors pursue truly obscure assets or strategies, however, in search of that elusive extra percentage point of return. Laurie Bachelder, a principal at NUA, suggests that advisors take a look at incorporating everything from airspace rights to farm animals into their clients' accounts, including their IRAs. "We have clients who have show horses in their retirement accounts," she says. "The horse is purchased in Europe, where it might be a silver medalist, and brought to the United States, where it is a gold medal-level competitor and can be sold at a higher value."

Other offbeat alternative investments include New York City bus stops; investors acquire the plastic shelter, complete with seats inside for passengers and—most important—a big space available to advertisers on which to plaster their message to New York's millions of pedestrians. "The advertising rights can be sold, so they are income-producing, which is a great characteristic when you're trying to get every ounce of performance out of a portfolio," Bachelder says. It may sound goofy, but she insists this approach is not only possible (with the appropriate level of due diligence and risk management, such as insuring the life of that show horse on its trans-Atlantic voyage), but is also becoming more mainstream. It's particularly appealing to clients who have a familiarity with the type of alternative under consideration. "A rancher might be comfortable with horses or a doctor with MRI machines purchased by his IRA and installed in his own hospital, where they generate income."

To some veteran advisors, trying to develop an athletic portfolio is a disservice to clients. "You can't make an asset work harder; it's going to return what it will return, and when you try and boost that return, you do so only by adding more risk," argues Luke Ferraro, a principal at Moneta Group, who prefers to manage risk.

Indeed, advisors who try to make their portfolios more athletic and work harder need to remember that hanging on to those extra returns is just as critical as earning them in the first place. That means paying extra attention to issues like counterparty risk on those intriguing new structured notes (Do you want to end up with the next Bear Stearns as your counterparty?) and liquidity (because it's no good picking a winner if you can't take your winnings off the table at the right time).

"In this environment, despite all the rhetoric about a new simplicity in financial markets, the real question is around opportunities," Olsen says. "There's always a certain elegance about simplicity. But there's nothing that says you can't be simple and straightforward at the same time you're being nimble and opportunistic, while giving your clients' portfolios a great workout."

Suzanne McGee is a New York-based freelance writer who has written about business and finance for two decades, including 14 years at The Wall Street Journal. She is working on a book about Wall Street, which will be published in 2010.

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