

Don't Overlook Asset Allocation



By Ronald A. Sirt

One interesting theme I discovered in my recent dealings with bank owners and senior executives is what I call the barbell approach to investing. Most clients invest the bulk of their assets in their own bank stock and round out their portfolio with investments in other banks. In addition, these clients tend to own a fair amount of real estate. Without exploring the actual financial planning process, I would like to focus on asset allocation within the equity component of the portfolio.

Equities are broadly categorized in two ways: market capitalization and investment style.

In reviewing portfolios, most bank owners and senior executives invest a large portion of their portfolio in their own bank's stock. These clients instinctively complement those holdings with large cap equity money managers or large cap equities.

According to Ibbotson Associates, 92 percent of a portfolio's investment return is determined by the strategic allocation. As a result, spend a fair amount of time concentrating on this area when reviewing and constructing portfolios.

Different sectors and investment categories respond to economic and market changes in various ways. For example, the

Benefits of Diversification (1997-2006)

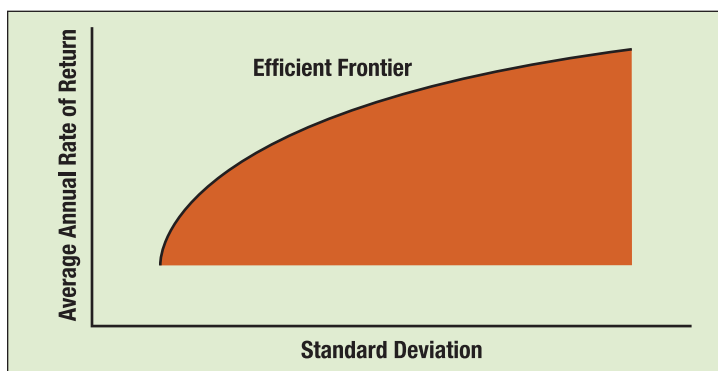
1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Large Cap Value 35.18%	Large Cap Growth 38.71%	Small Cap Growth 43.09%	Small Cap Value 22.83%	Small Cap Value 14.03%	Inter Bond 9.84%	Small Cap Growth 48.54%	Small Cap Value 22.25%	Int'l Equity 14.02%	Int'l Equity 26.86%
Small Cap Value 31.78%	Int'l Equity 20.33%	Large Cap Growth 33.16%	Inter Bond 10.12%	Inter Bond 8.96%	Small Cap Value -11.43%	Small Cap Value 46.03%	Int'l Equity 20.70%	Mid Cap 12.65%	Small Cap Value 23.48%
Large Cap Growth 30.49%	Large Cap Value 15.63%	Int'l Equity 27.30%	Mid Cap 8.25%	Large Cap Value -5.59%	Large Cap Value -15.52%	Mid Cap 40.08%	Mid Cap 20.22%	Large Cap Value 7.05%	Large Cap Value 22.25%
Mid Cap 29.01%	Mid Cap 10.10%	Mid Cap 18.23%	Large Cap Value 7.01%	Mid Cap -5.62%	Int'l Equity -15.66%	Int'l Equity 39.17%	Large Cap Value 16.49%	Large Cap Growth 5.26%	Mid Cap 15.28%
Small Cap Growth 12.95%	Inter Bond 8.44%	Large Cap Value 7.35%	Int'l Equity -13.96%	Small Cap Growth -9.23%	Mid Cap -16.18%	Large Cap Value 30.03%	Small Cap Growth 14.31%	Small Cap Value 4.71%	Small Cap Growth 13.35%
Inter Bond 7.87%	Small Cap Growth 1.23%	Inter Bond 0.39%	Large Cap Growth -22.42%	Large Cap Growth -20.42%	Large Cap Growth -27.88%	Large Cap Growth 29.75%	Large Cap Growth 6.30%	Small Cap Growth 4.15%	Large Cap Growth 9.07%
Int'l Equity 2.06%	Small Cap Value -6.45%	Small Cap Value -1.49%	Small Cap Value -22.43%	Int'l Equity -21.21%	Small Cap Growth -30.26%	Inter Bond 4.31%	Inter Bond 3.04%	Inter Bond 1.58%	Inter Bond 4.08%

Source: Mellon Analytical Services, LLC

market was extremely volatile during the past quarter ending Sept. 30th, which resulted in the following returns for the following sectors: according to the Oct. 1 edition of *The Wall Street Journal*: non-ferrous metals (19.9 percent) consumer electronics (18.7 percent) heavy construction (18.6 percent) and gambling

people consider an unacceptable amount of volatility. Volatility is the rate at which the price of a security changes over a certain time horizon, and is typically measured by standard deviation. As volatility increases, risk increases as well. Moreover, securities are usually more volatile over shorter time horizons.

Risk-Efficient Portfolios



Source: Howe Barnes

(16.2 percent). These sectors continued to outperform the more defensive sectors such as durable household products (-9.8 percent) and mortgage finance (-16.4 percent). Collectively, growth sectors outperformed value sectors regardless of capitalization with Mid Cap Growth leading the way at 14.6 percent year-to-date.

At any time different sectors and asset classes will outperform or under perform various benchmarks. See the periodical table (page 100). Large cap growth stocks may outperform emerging markets depending on the current market environment, and vice versa. Regardless, sophisticated planning requires a focus on asset allocation with tactical sector shifts and regular rebalancing.

Having a concentration of securities in two or three asset classes exposes a portfolio to what many

So what should an investor do? To maximize returns while managing risk, an investor should consider including higher growth, higher risk asset classes with other asset classes in a fiscally responsible manner, so that the fluctuations between asset classes are minimal. The science of constructing these risk-efficient portfolios is closely associated with highly respected Nobel laureate economists Harry Markowitz and Bill Sharpe. Properly combining securities in a well-structured portfolio allows an investor to enter a region bounded by an upward sloping curve commonly referred to as the *efficient frontier*, which is illustrated in graph above.

There are two important properties about the efficient frontier:

1. For any given value of stan-

dard deviation, an investor would like to optimize his returns. Portfolios falling below the efficient frontier are not optimal.

2. The efficient frontier is a curved line, which is a very important consideration. For example, consider a two stock portfolio with returns that tend to move in similar directions at similar times. Very little is accomplished by holding this second security in the portfolio, since the standard deviation is barely reduced due to the high covariance between the two securities.

When assembling a portfolio of securities an investor should choose money managers who have the ability to construct diversified portfolios. Many investors mistakenly assume that holding numerous securities or using several different money managers accomplishes this goal. But how the pieces of the puzzle are assembled matters greatly.

An investor should ensure that there is proper diversification among securities in his portfolio, including different market capitalizations, investment styles (such as growth and value), international versus domestic securities and fixed income versus equity securities. Once an investor establishes his tolerance for risk, a money manager can help structure a diversified portfolio to optimize returns at that risk level. **ib**

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