

**A Sample Defensive Portfolio**  
**March 2009**

An investor concerned about capital preservation and sharing our perspectives on the economy and the stock market would be well advised to limit his or her exposure to equities and to real estate. The attached schedule shows a sample defensive portfolio allocation for a \$1,000,000 portfolio. The total allocation to risky assets – including domestic and international stocks, real estate, and commodities – is less than 28%.

The schedule includes possible vehicles that might be used to invest in the various asset classes. In almost every case, the listed vehicle is a passively managed, low-cost, indexed mutual fund or exchange-traded fund. Investors have multiple options to choose from to invest in most of the listed asset classes. Those listed on the schedule are not necessarily recommended by the *Asset Allocation Advisor*, but are simply representative examples. Choices for the equity asset classes are reviewed in the Special Features article, “Buying the Markets, Putting Beta before Alpha,” at [www.aametrics.com](http://www.aametrics.com).

The sample defensive portfolio is not positioned to capitalize on a recovery in stock prices but to minimize the impact of further equity market losses. Equity exposures are minimized but not reduced to zero. The portfolio would generate a marginally positive return of less than 0.5% over the next twelve months if the asset classes produce the returns under the 1 Yr return column. Should the economy recover more quickly than we expect and investor confidence return, a defensive allocation like the one in the sample portfolio would significantly underperform other portfolios, and an investor in such a portfolio would miss the opportunity for significant capital appreciation. We think the prospects of such a near-term recovery, however, are less than the prospects of further losses. Investors need to be cautioned, nonetheless, that even a defensive portfolio has risks associated with it.

Investors who adopt a defensive allocation should have a strategy for increasing their exposures to risky assets in the future. We do not believe in market timing, and would not advise defensive investors to wait until signs of an improving economy or stock market were evident. It will be too late by then, and investors are likely to have missed out on a portion of the upside opportunity. Investors, therefore, have to adopt a strategy of buying into what is likely to be a declining market once a certain benchmark has been reached – either a price level, a calendar date, or an economic indicator level. As noted in the Capital Markets Outlook for March 2009, this has typically been the case in past recoveries: stock valuations begin to increase before earnings reach their low point. At this time, we think it is premature to be setting benchmarks for a recovery, but we will provide some thoughts on the matter in an upcoming article.

Lastly, a note on the asset classes: investors may be surprised to see a significant allocation to mortgage-backed securities (MBSs) in the sample defensive allocation. In the case of this asset class, the choice of a vehicle is critical as investors do not want to be exposed to securities that can be tainted by the fallout from the sub-prime crisis. The specified vehicle in the sample portfolio is a fund that invests in GNMA securities, which have the explicit backing of the United States government. Funds are available that invest in a wider range of MBS securities including those of Fannie Mae (FNMA or the Federal National Mortgage Association) or Freddie Mac (FHLMC or the Federal Home Loan Mortgage Corporation). Although most analysts, including this author, would say that both Fannie Mae and Freddie Mac have the de facto guarantee of the United States behind them, this guarantee has not been made explicit. In fact, the most recent

annual report (on form 10-K) for the year ended December 31, 2008 and filed with the SEC states:

“Although we are a corporation chartered by the U.S. Congress, and although our conservator is a U.S. government agency and Treasury owns our senior preferred stock and a warrant to purchase our common stock, the U.S. government does not guarantee, directly or indirectly our securities or other obligations.”

As such, an investment in a fund that invests in FNMA and FHLMC MBSs may be subject to more risk.

## Sample Defensive Portfolio Allocation

March 13, 2009

Asset Class	\$s	%	Ticker	Description	1 Yr return	3 Yr return	LT return
<b>STOCKS</b>							
Domestic							
Large Cap	45,000.00	4.50%	SPY	S&P 500 Index (SPDRs) ETF	-20.0%	6.0%	12.0%
Mid Cap	23,000.00	2.30%	MDY	S&P 400 Midcap SPDRs ETF	-20.0%	7.0%	14.0%
Small Cap	22,000.00	2.20%	IJR	iShares S&P SmallCap 600 Index fund	-20.0%	8.0%	17.0%
<b>Total domestic</b>	<b>90,000.00</b>	<b>9.00%</b>			<b>-20.00%</b>	<b>6.74%</b>	<b>13.73%</b>
International							
UK	15,000.00	1.50%	EWU	iShares MSCI United Kingdom Index Fund	-25.0%	5.0%	12.0%
Euro area	20,000.00	2.00%	FEZ	State Street Global Advisors DJ Euro STOXX 50 ETF	-20.0%	6.0%	13.5%
Japan	15,000.00	1.50%	EWJ	iShares MSCI Japan Index ETF	-20.0%	4.0%	15.0%
Emerging markets	25,000.00	2.50%	VWO	Vanguard Emerging Markets ETF	0.0%	8.0%	20.0%
<b>Total international</b>	<b>75,000.00</b>	<b>7.50%</b>			<b>-14.33%</b>	<b>6.07%</b>	<b>15.67%</b>
<b>Total Stocks</b>	<b>165,000.00</b>	<b>16.50%</b>			<b>-17.42%</b>	<b>6.44%</b>	<b>14.61%</b>
<b>ALTERNATIVE INVESTMENTS</b>							
Real estate - domestic	15,000.00	1.50%	VGSLX	Vanguard REIT Index Fund	0.0%	5.0%	15.0%
Real estate - foreign	15,000.00	1.50%	IFGL	iShares FTSE Global Real Estate Ex-US Index Fund	0.0%	5.0%	16.0%
Commodities - GSCI Index	40,000.00	4.00%	GSG	iShares GSCI Commodity Indexed Trust	5.0%	5.0%	8.0%
Commodities - DJAIG Index	30,000.00	3.00%	DJP	iPath Dow Jones AIG Commodity Index Total Return ETN	4.0%	5.0%	8.0%
<b>Total Alternative Investments</b>	<b>100,000.00</b>	<b>10.00%</b>			<b>3.20%</b>	<b>5.00%</b>	<b>10.25%</b>
<b>BONDS</b>							
US intermediate-term government bonds	75,000.00	7.50%	VFITX	Vanguard Intermediate-Term Treasury Fund	2.5%	3.0%	5.4%
US long-term government bonds	25,000.00	2.50%	TLT	iShares Barclays 20+ year Treasury Index ETF	4.0%	4.0%	5.8%
US TIPS (inflation-indexed bonds)	100,000.00	10.00%	VAIPX	Vanguard Inflation Protected Securities Fund	2.5%	4.0%	5.5%
US intermediate-term corporate bonds	50,000.00	5.00%	VFICX	Vanguard Intermediate Term Investment Grade Fund	8.0%	7.0%	6.0%
US long-term corporate bonds	50,000.00	5.00%	VWESX	Vanguard Long Term Investment Grade Fund	8.0%	8.0%	6.2%
US high-yield bonds	-	0.00%	VWEAX	Vanguard High Yield Corporate Fund	0.0%	2.0%	10.0%
US MBS (fixed rate, govt guaranteed)	200,000.00	20.00%	VFIJX	Vanguard GNMA Fund	5.5%	5.5%	6.6%
Foreign treasury bonds	30,000.00	3.00%	BWX	SPDR Barclays Capital International Treasury Bond ETF	4.0%	4.0%	7.0%
Foreign inflation-indexed bonds	20,000.00	2.00%	WIP	SPDR DB International Inflation-indexed Bond ETF	4.5%	4.0%	6.5%
<b>Total Bonds</b>	<b>550,000.00</b>	<b>55.00%</b>			<b>4.81%</b>	<b>5.05%</b>	<b>6.13%</b>
<b>CASH</b>							
Cash	185,000.00	18.50%		Short-term Treasury fund, Bank CD, or Guaranteed MMA	1.0%	2.0%	3.0%
<b>Total Portfolio</b>	<b>1,000,000.00</b>	<b>100.00%</b>			<b>0.28%</b>	<b>4.71%</b>	<b>7.36%</b>