

Tracking the Ten Percent Portfolios Meeting the Target

In last summer's issue of the *Asset Allocation Advisor*, we provided optimal portfolios with expected three-to-five year annual returns of ten percent, with and without venture capital. Although we should be wary of measuring the effectiveness of the portfolios on the basis of relatively short-term results, we can't help but ask how they would have performed during the recent financial turbulence. We report on results for the periods from 31 July to 31 December 2007 and for the first half of 2008.

In the period from July 31 to December 31, both portfolios exceeded the target ten percent annual return. The portfolio without venture capital had a total return for the period of 5.9%, or 14.0% annualized. For the portfolio including venture capital, we have to make assumptions regarding venture capital returns, since no generic venture capital investment vehicle exists. On a total market basis, as measured by the Sand Hill Index of venture capital, venture capital lost 0.5% from August through December 2007. Returns on individual venture capital deals are certain to vary substantially from this average. Assuming a zero return for the period, the portfolio returned 6.0% for the period, or 14.3% annualized. Assuming a 0.5% loss for the period, the portfolio returned just less than 6.0% for the period. Even with an assumed return of -19% for the period for venture capital, the portfolio would have still exceeded the ten percent return target. By comparison, a portfolio with a traditional 65/35 domestic stock/bond allocation produced a total return of 2.4% from August through December 2007.

The Ten Percent Portfolios also exceeded the target ten percent annual return in the period from 1 January through 30 June 2008 despite losses in equity markets around the world in the first half of 2008. The portfolio without venture capital had a total return of 5.7% or 11.4% on an annualized basis. The portfolio including venture capital also exceeded the target during the period. Assuming a return of 0% on venture capital for the period, the portfolio had a total return of 6.8%. By comparison, the traditional 65/35 domestic stock/bond portfolio lost 6.7% in the first half of the year. Total returns on the Ten Percent Portfolios exceeded this return by more than twelve percent (12%) and exceeded the return on the S&P 500 by more than seventeen percent (17%). Organizations that used the Ten Percent Portfolios as guides for their own asset allocations should have experienced similar results.

Figure TP.1 shows the portfolio returns for the end of last year and the first half of 2008 with component results. Readers should note that the investment vehicles reported here for each asset class were not specified when the ten percent portfolios were specified. Alternative vehicles are available for many of the asset classes, and those alternatives may have had returns different from the ones reported for the vehicles here. Alternative investment options for the various equity categories are discussed in the article "Buying the Markets," which will appear in the next issue of the *Advisor*. Options for fixed-income and alternative investment categories will be discussed in the following issue. With one exception, all of the investment vehicles are passively-managed index funds. The one exception is in the case of foreign investment-grade bonds, for which there does

not appear to be any passively managed index fund currently available. The specified fund, the FFTW International Fund, is an actively managed mutual bond fund. Total portfolio returns for both periods assume a starting allocation consistent with the model portfolio and assume the reinvestment of dividends or interest. Please note that the inclusion of a mutual fund or exchange-traded fund in Figure TP.1 is not to be construed as a recommendation to purchase the fund.

Figures TP.2 and TP.3 compare the contributions made by each asset category to total portfolio returns for the periods 31 July through 31 December 2007 and 1 January through 30 June 2008 respectively. Each chart takes into account both the allocation and the performance for each asset category during the period. Commodities were the largest contributor to total returns for both portfolios for both periods. Emerging-market stocks, mortgage-backed bonds, and euro area stocks were the second, third, and fourth largest contributors respectively to the total return of the portfolio without venture capital during the period from 31 July to 31 December 2007. Emerging-market stocks, mortgage-backed bonds, and high-yield bonds were the second, third, and fourth largest contributors respectively to the total return of the portfolio including venture capital for the same period. The bond categories made larger contributions to the portfolio including venture capital due to their larger allocations. U.S. small-cap stocks, Japan stocks, and real estate made negative contributions to portfolio returns for the period.

For the first half of 2008, commodities provided virtually all of the return for both portfolios, with and without venture capital. Small contributions were also provided by intermediate-term Treasuries, long-term Treasuries, inflated-protected Treasuries (TIPS), mortgage-backed bonds, and foreign investment-grade bonds. All other asset categories produced losses for the first half of 2008, including all domestic and international equity categories.

The rather surprising results of the Ten Percent Portfolios during a time when equity markets in the United States, Europe, and the emerging markets produced losses of ten percent or more for investors are a tribute to the advantage of broad diversification. Although a slower pace of economic growth throughout the world (with likely contractions in the United States, the UK, and parts of Europe) is likely to depress all capital market returns, diversification will continue to be of benefit – even if not so heroically as over the past eleven months.

Readers are cautioned that the compositions of the Ten Percent Portfolios are under review and are likely to change in view of revised capital market expectations. Revised allocations will be forthcoming soon. Stay tuned.

Ten Percent Portfolios Total Returns

Asset category	Investment option	symbol	Total returns for period		Portfolio allocations	
			Jul 31 – Dec 31	Jan 1 – Jun 30	Without venture capital	With venture capital
U.S. large-cap stocks	SPDRs	SPY	1.3%	-11.6%	15.5%	7.30%
U.S. small-cap stocks	iShares, S&P SmallCap 600 Index ETF	IJR	-3.2%	-7.1%	13.1	10.8
UK stocks	iShares MSCI UK Index ETF	EWU	0.9%	-12.0%	8.0	3.3
Euro area stocks	DJ Euro STOXX 50 ETF	FEZ	9.9%	-15.6%	3.8	2.3
Japan stocks	iShares S&P/TOPIX 150 Index ETF	ITF	-7.3%	-4.3%	6.7	4.8
Emerging-market stocks	Vanguard Emerging Markets ETF	VWO	12.4%	-10.3%	4.4	5.0
Venture capital			*	*	0.0	9.3
Real estate	Vanguard REIT ETF	VNQ	-3.0%	-2.9%	5.9	7.7
Commodities	iShares S&P GSXI Commodity-Indexed Trust ETF	GSG	18.5%	42.0%	25.7	23.7
Intermediate-term Treasuries	iShares Lehman 3-7 Year Treasury ETF	IEI	6.9%	2.4%	0.1	0.7
Long-term Treasuries	iShares Lehman 20+ Year Treasury ETF	TLT	8.7%	1.1%	1.5	2.2
TIPS	iShares Lehman TIPS Bond ETF	TIP	7.6%	4.8%	0.5	1.2
Long-term corporate bonds	iShares iBoxx Investment Grade Corporate Bond ETF	LQD	4.3%	-1.1%	0.8	1.2
High-yield bonds	iShares iBoxx High Yield Corporate Bond ETF	HYG	7.5%	-3.6%	2.5	4.0
Mortgage-backed bonds	iShares Lehman MBS Fixed-rate Bond ETF	MBB	5.2%	1.3%	7.9	11.5
Foreign investment-grade bonds	Fischer Francis Trees & Watts, International Portfolio Bond Fund	FFIFX	7.5%	3.8%	2.1	2.9
Emerging market sovereign debt	PowerShares Emerging Markets Sovereign Debt Portfolio ETF	PCY	4.7%**	-3.7%	1.5	2.1
Total					100.0%	100.0%
			Total return for Jul 31 – Dec 31		5.89%	6.01%*
			Total return for Jan 1 – Jun 30		5.68%	6.77%*

* Total returns calculated assuming 0% return for venture capital where applicable, see text for alternatives
 ** Return for period assumes 3% average annual return until inception of fund on 11 October 2007

Figure TP.1: Ten Percent Portfolios Total Returns

Source: Bloomberg and *Advisor* calculations

Ten Percent Portfolio Return Contributions by Asset Category
For the period 31 July to 31 December 2007

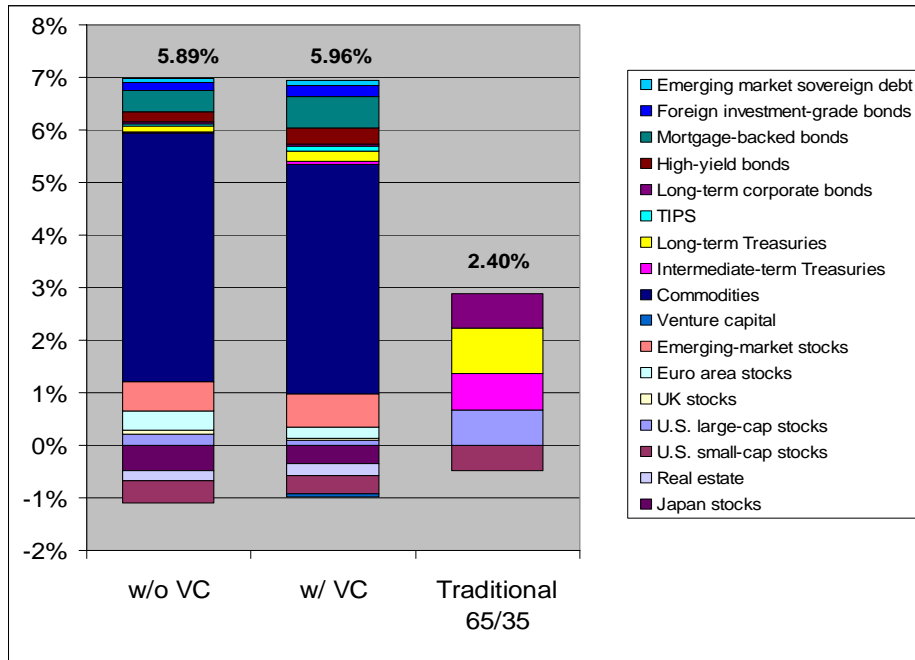


Figure TP.2: Return Contributions by Asset Category
Source: Bloomberg and *Advisor* calculations

Ten Percent Portfolio Return Contributions by Asset Category
For the period 1 January to 30 June 2008

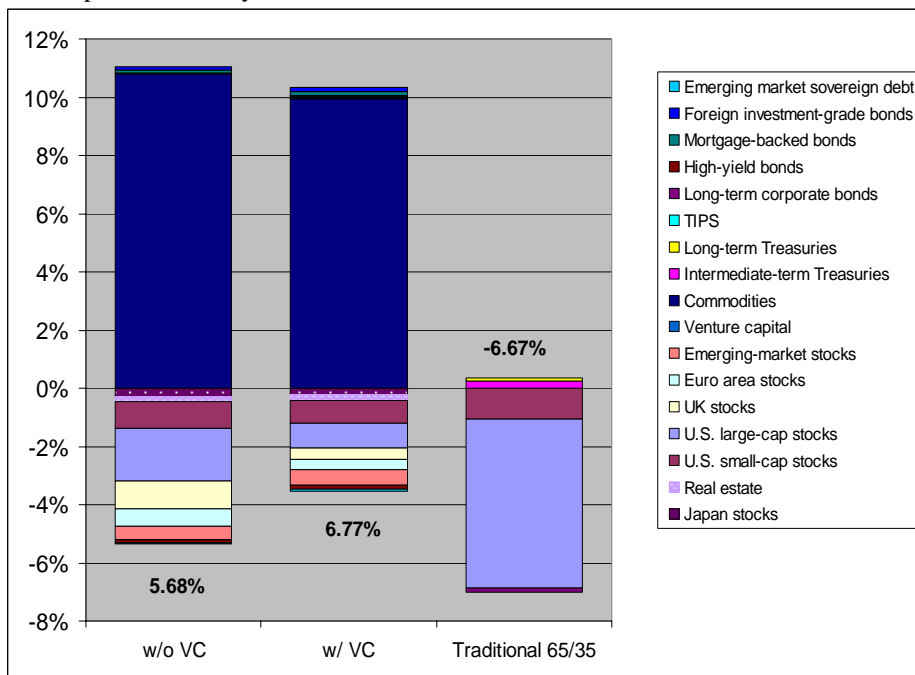


Figure TP.3: Return Contributions by Asset Category
Source: Bloomberg and *Advisor* calculations