



One up on Wall Street for the 21st Century

Peter Lynch, Fidelity's star fund manager, penned the popular *One up on Wall Street* in 1990, followed by the even more popular *Beating the Street* in 1993. For many investors, these two books were the primary "enablers" for a generation of stock pickers similar to Ben Graham's *Security Analysis* and *The Intelligent Investor*, which ignited a previous generation of investors in the 1940s and 1950s. Lynch not only offered sage advice from a recognized expert, he attempted to make the complicated world of stock investing simple. Readers were left with the impression that "one upping" Wall Street was easy, and budding investors were encouraged to keep their eyes and ears open for the profitable investment opportunities that lurked around every corner.

Unfortunately, times have changed. Today's investment world is very different from the one in which Peter Lynch and Ben Graham practiced. For that reason, we believe one-upping Wall Street demands an updated approach that extends beyond the advice written in their books.

How We Think Wall Street Has Changed

1. Talent:

- **Yesterday:** The competitive landscape facing Graham and Lynch was less crowded and less ruthless. We think the late-Peter Bernstein, speaking at a December 2008 CFA Institute event, summarized it best when he described Wall Street at the beginning of his investment career in 1951:

To give you an idea of what the investment world was like in 1951, only two of my classmates from Harvard were on Wall Street: One of them was named J.P. Morgan III, and the other was also the son of a Wall Street father. In those days, no one went into finance...people failed to recognize the promising environment.

- **Today:** The best and brightest generally go where their talents and intellect is best rewarded. Over the past few decades, one of those places has been Wall Street. The pay-off for the truly talented seems to rise every year despite the economic or financial market backdrop. To underscore this point, *Alpha*, a publication of *Institutional Investor* magazine reported that in 2008 (a year when the S&P declined nearly 40%), the top 25 hedge fund managers earned \$11.6 billion, with four individual hedge fund managers each taking home more than \$1 billion.

2. Information:

- **Yesterday:** Ten years ago, investors could gain a competitive advantage by simply having good access to information. For example, we can remember the feeling of "informational superiority" we felt throughout the 1990s because we were able to listen in on our firm's institutional morning call, and due to our proximity to the research analysts and traders. Back then, analysts could earn their stripes by providing investors with access to a company's management team and by piecing together industry data points from expensive and narrowly circulated trade magazines. The top-rated might have gone a step further by performing proprietary "channel checks" through their own panel of outside experts.
- **Today:** Information is now ubiquitous through the Internet, and Regulation Fair Disclosure (Reg FD) has limited the value of talking to management teams. For these reasons, there are few competitive advantages in accessing a research report or listening to an earnings call, because anyone can do the same. Information advantages can still be attained, but they come at steeper costs. Expert networks, for example, are new and costly tools that seem to be growing in popularity among the institutional crowd. Today, for \$5,000 – \$20,000, investors can assemble a panel of experts through a third party in order to conduct their own channel checks or to gain insight beyond what they are hearing from management or analysts.

3. Tools:

- **Yesterday:** In the past, investment success could be achieved by finding a viable strategy and applying it. Popular investment books highlighted the power of purchasing stocks with certain characteristics, such as a low price/sales ratio and rising relative strength. Academics joined the debate with their studies and papers, which highlighted specific anomalies, such as the level of a company's accruals, that could serve as a good proxy for potential future outperformance or underperformance.
- **Today:** There are currently a lot of PhDs back testing thousands of individual strategies, or combinations of strategies, in an attempt to outperform the market. When a successful strategy is identified, it is quickly incorporated into models and exploited by many quantitative investment firms until its alpha-generating capabilities are exhausted. For this reason we believe that many historically successful and time-tested investment strategies have begun to lose their efficacy.

One Upping Wall Street Requires a New Strategy: In our view, trying to beat Wall Street at its own game is difficult and rarely fruitful. There will always be competitors with an information advantage due to their deeper list of contacts and seemingly infinite research budgets. **Therefore, we believe the key to one-upping Wall Street over time is an investor’s willingness to employ different strategies.** Wall Street has multiple weaknesses and biases, which we believe can be identified and exploited. We think these opportunities, which we highlight on the following pages, offer investors a 21st century approach to “*beating the Street.*”

ETFs -- An Enabling Technology for Beating Wall Street in the 21st Century

Before outlining the opportunities, we think it’s important to dedicate a few paragraphs to one of the critical enabling technologies that we believe is empowering the average investor in this new frontier -- the exchange-traded fund (ETF). ETFs have grown in popularity over the last decade, having been trumpeted as an attractive and low-cost complement to traditional investment approaches, such as buying individual stocks, bonds, and mutual funds. Having managed portfolios that have extensively incorporated ETFs for more than six years, we have experienced their power and flexibility first-hand. We strongly believe ETFs are “game changers” in the investment industry and should be viewed as a necessary and meaningful component of any investment strategy.

ETFs Can Deliver Alpha: Alpha refers to the performance differential between a specific investment and its benchmark. For a large-cap stock, alpha describes the degree to which a company performed differently than the S&P 500. One of the early knocks on ETF investing was that since an ETF was simply a broad basket of securities, investors were locked-in to average performance. Fortunately, this is simply not true. The broad product set available to ETF investors ensures a wide dispersion of returns among ETFs and ample opportunity to beat the market with the appropriate strategies. To drive this point home, Table 1 provides a recent examples of how differently ETFs with similar names can perform. From the table below, it is evident that ETF returns can vary, and those variations can be significant even over a short period of time. These differences extend well beyond what may be explained by the relative variations in liquidity or expense ratios. We view the data in the table as validation of the power of ETF investing and as proof that an investor can potentially add value by choosing among ETFs and is far from condoned to average performance.

Table 1: Large-Cap Index Comparison

Index	13-Week Percentage Change (as of 3/1/10)
NYSE Composite	(1.91%)
S&P 500	0.46%
Russell 1000	1.13%
FTSE RAFI US 1000	2.52%
Nasdaq-100	2.78%

Over 13 weeks, the differential between the worst and best large-cap indices is 469 basis points!

Data Courtesy RiverFront Investment Group

Strategies for Outperformance

1. Include Additional Asset Classes. Modern Portfolio Theory (MPT) has its fans and its critics, yet most agree on its basic tenet — higher risk-adjusted returns can be achieved by combining asset classes with unique risk, return, and correlation characteristics. Therefore, the first strategy for attempting to *one-up* Wall Street involves the implementation of additional asset classes within portfolios. Asset classes that had traditionally been considered institutional due to their high minimum investment levels or inaccessibility can now be included in traditional portfolios via ETFs. For example, commodities, which we view as an appealing asset class due to its historically low correlation with stocks and bonds, has been off limits to many investors because of specific licensing requirements and high investment minimums. Today, investors can purchase commodities through broad diversified ETF baskets or through focused ETFs that track individual commodities, such as oil or sugar. We believe optimally constructed portfolios include allocations to unique asset classes like commodities and others listed in Table 2. In Table 3, we highlight additional asset classes that we believe show some promise of being unique and thus may play a role in increasing risk-adjusted returns.

Table 2: Unique Asset Classes

Asset Class	ETF Implementation
Emerging Market Equity ¹	Vanguard Emerging Market (VWO-NYSEArca-\$41.05)
Commodities ²	PowerShares DB Core Commodity (DBC-NYSEArca-\$23.91)
Emerging Market Debt	PowerShares Emerging Market Debt (PCY-NYSEArca-\$25.97)
Master Limited Partnerships (MLPs)	JP Morgan Alerian MLP ETN (AMJ-NYSEArca-\$29.99)
Real Estate Investment Trusts (REITs) ³	iShares DJ US Real Estate (IYR-NYSEArca-\$48.03)

1. Investments in international and emerging markets securities include exposure to risks including currency fluctuations, foreign taxes and regulations, and the potential for illiquid markets and political instability.
2. Buying commodities allows for a source of diversification for those sophisticated persons who wish to add this asset class to their portfolios and who are prepared to assume the risks inherent in the commodities market. Any commodity purchase represents a transaction in a non-income-producing asset and is highly speculative. Therefore, commodities should not represent a significant portion of an individual’s portfolio.
3. There are special risks associated with an investment in real estate, including credit risk, interest rate fluctuations and the impact of varied economic conditions.

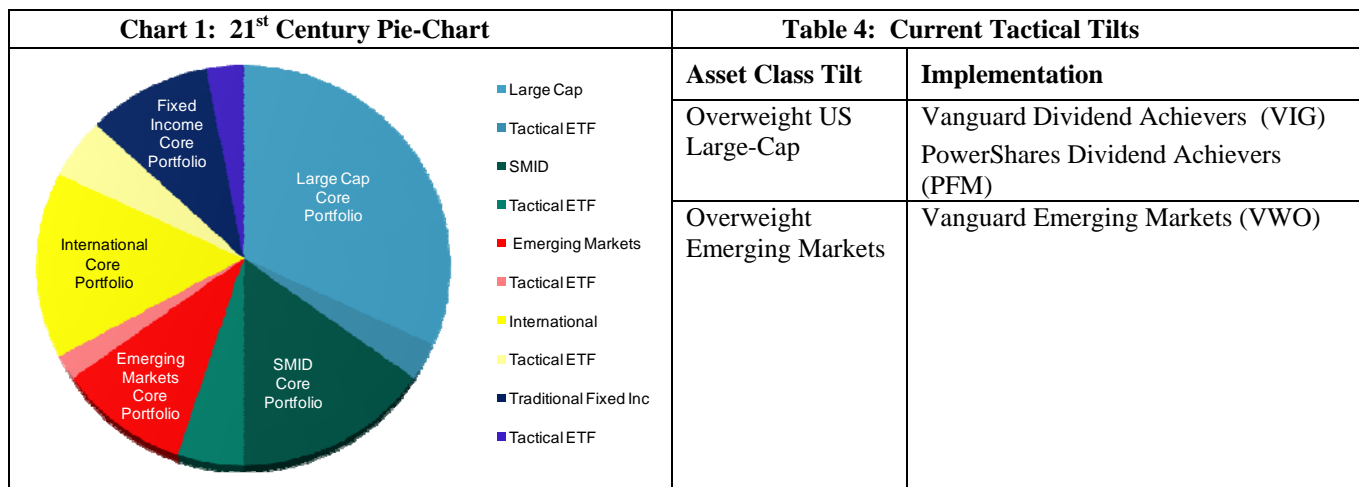
Table 3: Potentially Unique Asset Classes

Asset Class	ETF Implementation
Dividend Growth Stock ⁴	Vanguard Dividend Achiever (VIG-NYSEArca-\$48.08) PowerShares Dividend Achiever (PFM-NYSEArca-\$12.78) SPDR Dividend Aristocrats (SDY-NYSEArca-\$48.43)
Buy-Write Strategies	PowerShares S&P 500 Buy-Write (PBP-NYSEArca-\$21.71)
Convertible Bonds	SPDR Convertible Bond (CWB-NYSEArca-\$38.74)
MicroCaps	iShares Russell Microcap (IWC-NYSEArca-\$42.59) PowerShares Zacks Microcap (PZI-NYSEArca-\$10.58)
Alternative Investments	iShares Alternative (ALT-NYSEArca-\$49.30)
Currency	PowerShares U.S. Dollar Up (UUP-NYSEArca-\$23.62)

4. Dividends are not guaranteed and are subject to change or elimination.

2. Incorporate the Flexibility to be Tactical: In our experience, no fix-it-and-forget-it allocation can withstand the test of time and the markets. RiverFront research suggests that, over a period of years, the price paid for an investment relative to its long-term trend can account for approximately 60-90% of return. Therefore, we believe that investment pie charts need to be dynamic. For instance, conservative growth investors, who may typically hold 60% of their assets in equities and 40% of their assets in bonds, should not maintain a 60/40 allocation in all market environments. If price truly matters, as our research has shown, then a 60/40 investor should possess less than 60% equities when equities are rich, as they were in 1998, and more than 60% when they are cheap, like they are today.

In our view, a dynamic approach to pie-chart construction can be an effective strategy for *one-upping* Wall Street, yet few investors focus on it. One reason for this apathy is structural, in our opinion. Historically, asset allocation shifts have been difficult, time-consuming, and costly to implement with portfolios constructed in a traditional manner. We believe the invention and evolution of the ETF has changed that dynamic forever. ETFs, in our view, play a critical role in making portfolios more flexible and responsive. RiverFront allocates its investment dollars across asset classes in two ways: (1) the first allocation goes to traditional or active strategies and is allocated to vehicles such as individual large-cap stocks; (2) the second allocation is to tactical or swing, and is invested in an asset class ETF, such as the SPDR S&P 500 (SPY-NYSEArca-\$114.27). In this way, portfolio managers can quickly expand or reduce their asset class allocations without disrupting the underlying engine of the portfolio. The implementation of this process has allowed client portfolios to evolve from fix-it-and-forget-it to anticipate-and-recalibrate. Chart 1 displays how a portfolio looks using this framework. Table 4, next to the chart, highlights a few of our current tactical tilts and favored implementation vehicles.



3. Allocation can be more Important than Selection: We think how an investor allocates to sectors and industry groups can be more important than the individual stocks an investor selects. Fortunately, allocation decisions continue to be underappreciated by the majority of investors, making it an attractive opportunity, in our view. Many investment firms tend to be “selection heavy,” employing a much higher number of analysts focused on stock picking than they employ to provide asset class or sector weighting advice. In our opinion, this does not make sense. Professional poker players, for example, recognize the importance of allocation relative to selection and spend countless hours refining and practicing “chip management” skills. These professionals have found that a good chip management system often beats a good hand; and unlike a good hand, luck is not the deciding factor. We see two allocation strategies enabled by ETFs in which an investor can potentially gain an advantage on Wall Street.

- **Investing “Outside the Box”:** Because of its structure, Wall Street generally thinks inside the box. The analysts and portfolio managers that work within these firms are often restricted by job descriptions and investment policy statements to

operate within certain arbitrary boundaries, such as “large-cap,” “growth” or “technology.” We have seen these constraints lead to sub-optimal investment decisions on many occasions, and we believe that they can be exploited by those willing to invest outside the box.

A broad mandate investor is able to pursue the most attractive investment opportunities regardless of how they are classified. For example, portfolios that were made up of mid-cap value stocks in 2002 should be free to consist mainly of large-cap growth stocks in 2010, since that is where we believe the opportunity set has shifted. Likewise, investors should be willing to move among sector and industry groups as conditions warrant. While a Wall Street semiconductor analyst may be restricted to comparing and contrasting one semiconductor stock relative to another, an investor should not be. Broad-mandate investors should be willing to compare semiconductor stocks against trucking stocks or stocks in any other industry. We believe these cross-industry comparisons offer the greatest value, yet garner the fewest resources across the investment community. A few of the cross-industry bets we currently like are included in Table 5.

Table 5: Examples of RiverFront’s Current Sector and Industry Allocations

Instead of:	We Prefer:	Implementation Vehicle
Consumer Staples	Healthcare	iShares Pharmaceutical (IHE-NYSEArca-\$58.24) PowerShares Pharmaceutical (PJP-NYSEArca-\$19.53)
Telecom	Cable and Broadcasting	PowerShares Media (PBS-NYSEArca-\$12.87)
Capital Machinery	Semiconductors	SPDR Semiconductor (XSD-NYSEArca-\$47.45)
Chemicals	Metals & Mining	SPDR Metals & Mining (XME-NYSEArca-\$56.02)

- Equal Weighting Beats Capitalization Weighting Over Time:** At RiverFront, we are critical of market capitalization weighting methodologies and the indexes that track them. We agree with Robert Arnott, founder of Research Affiliates, LLC, and long-time critic of cap-weighting, when he argues that a cap-weighted methodology forces investors to buy high and sell low. However, while Wall Street may not agree with cap-weighting, most Wall Street managers are still measured and incentivized against cap-weighted benchmarks. This perversity encourages the Street to employ sub-optimal investment strategies to minimize the risk of underperforming their benchmarks. Fortunately, there are managers who are not bound by these restrictions and are free to follow strategies that are not cap-weighted. Today, there are a number of weighting strategies not related to market capitalization that investors can employ in their portfolios using ETFs. Options range from simple equal weighting to the more sophisticated fundamental or dividend weighting. While we think non-capitalization weighted solutions can be effective in all asset classes and equity sectors, we particularly recommend alternative strategies in areas in which a small number of companies could potentially dominate the traditional cap weighted indexes. Table 6 includes a few examples.

Table 6: Opportunities to Equal Weight

Asset Class or Sector	Potential Problem with Market-Cap Weighting	Potential Solution
S&P 500	Top 10 positions account for nearly 20% of the S&P 500 Index	Rydex S&P 500 Equal-Weight (RSP-NYSEArca-\$41.53) PowerShares FTSE RAFI 1000 Fundamental (PRF-NYSEArca-\$50.17)
Industrials	General Electric (GE) continues to dominate the Industrial sector, accounting for almost 20% of the S&P 500 Industrial Index	Vanguard Industrials (VIS-NYSEArca-\$54.78)
Energy	Exxon Mobil (XOM) and Chevron (CVX) account for 40% of S&P 500 Energy Index	PowerShares Energy (PXI-NYSEArca-\$28.35)
Biotechnology	Amgen (AMGN) and Gilead Sciences (GILD) make up 20% of the Nasdaq Biotech Index	SPDR Biotech (XBI-NYSEArca-\$59.18)

- Outperform by Managing Risk:** Avoiding the next torpedo can be as important as discovering the next rocket. But, we believe too much time is spent by investors searching for a home-run stock pick, such as Google (GOOG-NasdaqGS-\$562.48), which has grown to 1.3% of the S&P 500 since its IPO in 2004. The problem with Google and companies like it is that they are rare, and lots of investors are looking for them. In our view, an investor’s labor can be utilized more fruitfully searching for portfolio torpedoes, like General Electric (GE-N-\$16.27), and avoiding them. Avoiding secular underperformers is one of the most valuable strategies an investor can employ, in our view, since the damage inflicted by these companies can be great. For example,

General Electric, at its peak about ten years ago, represented more than 6% of the S&P 500 and was owned by nearly every large-cap portfolio manager. Since then, GE's share of the S&P 500 has dwindled to under 2%, which means an average large-cap investor with a 6% GE position a decade ago would have needed three Googles in their portfolio to offset the hole left behind by that stock.

The opportunity for the 21st century investor, we believe, is in the fact that risk management is infrequently practiced by Wall Street, and therefore can be an important path to outperformance for those who embrace it. We believe ETFs provide an important tool for risk management. For many investors, stocks are more than just pieces of paper, they represent ownership in a company made up of people, products, and philosophies that can create an emotional bond and a willingness to "look for the good" in a company. However, emotions can get in the way of rational decision making and often create a blind spot to obvious flaws. Since ETFs are essentially just baskets of stocks, they rarely come with the same emotional baggage present in individual stocks and bonds. Therefore, we have found it easier to manage risk using ETFs since mistakes are less hidden behind "good" stories or "improving" fundamentals.

Bottom Line: One of our favorite investing books is *Moneyball: The Art of Winning an Unfair Game* written by Michael Lewis in 2003. The book is the story of Major League Baseball's Oakland Athletics, which posted one of the league's best records under general manager Billy Beane, despite its league-low payroll. According to Lewis, the A's were successful because they recognized that they could not beat the league's richer teams, such as the New York Yankees, at their own game. To succeed, the A's deployed a statistical strategy that focused on finding value where no one else was looking.

We believe investors can learn something from Billy Beane and his management of the Oakland A's. Today's investors are competing against the most skilled investors in the world, who possess unlimited information and the most expensive tools. One can try to beat Wall Street at its own game, or forge a different path investing on principles and strategies that are less crowded. We believe that by including additional asset classes, incorporating a flexibility to be tactical, recognizing the importance of allocation, and implementing risk management, the 21st century investor has the potential to beat Wall Street for another decade.

For additional information on investing and the utilization of ETFs, please see our previous educational pieces on RiverFront website. A few of these pieces are listed below:

- 1/26/10: *Concentrated Positions*
- 9/29/09: *When to Buy a Stock, When to Buy an ETF*
- 8/24/09: *ETFs versus Stocks – When to use the Shotgun and When to use the Rifle*
- 3/25/09: *Commodities Survival Guide: An Essential "How To" Primer for Investors*
- 12/08/08: *During Tough Times, ETFs Shine*
- 5/5/08: *ETFs: Active Tool not Passive Placeholder*

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