THE Strategic View

RIVERFRONT INVESTMENT GROUP

Asset Management • Investment Strategy • Advice

Michael Jones, CFA, Chairman & Chief Investment Officer

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Dynamic Strategic Allocation versus Traditional Asset Allocation Methodologies

Investment advisors generally agree that asset allocation is the primary driver of investment returns, but often disagree as to the best way to determine an appropriate asset allocation strategy. For much of the past 40 years, the investment community has largely been divided into two camps regarding asset allocation strategy – "Traditional Strategic Allocation" or "Market Timing." At Riverfront, we developed a different way of setting asset allocation strategy -- "Dynamic Strategic Allocation (DSA)" – that we believe incorporates the best aspects of the traditional approaches while also incorporating our proprietary concepts and methodologies. Because we receive so many questions regarding the differences between DSA and the two prevailing asset allocation approaches, this report briefly compares and contrasts the main features of all three asset allocation methodologies[1]. Our goal is to help Financial Advisors better understand the assumptions underlying each approach.

Traditional Strategic Allocation

Traditional Strategic Allocators (TSAs) are generally rigid adherents to the Efficient Markets Hypothesis (EMH) and the work of Harry Markowitz. A key assumption of EMH is that market returns are random and unpredictable (similar to flipping a coin). Under this theory, expected returns do not change very much and therefore the asset allocation strategy is largely static from year to year ("fix it and forget it"). The primary driver of asset allocation strategy is the client's ability to tolerate potential losses, with higher risk tolerance allowing for bigger allocations to higher returning "risky" assets. The level of potential loss within a particular asset allocation strategy is calculated by inputting historical measures of risk (volatility and correlation) into Markowitz's mathematical models.

Under TSA, the asset allocation strategy is usually changed only if the client's risk tolerance changes. As a result, the potential losses experienced by the client depend upon their level of risk and the accuracy of the assumptions built into Markowitz's risk-measurement models. Some of the more important assumptions underlying these risk models include an assumption that correlations between asset classes do not change, and that market returns are normally distributed around the long-term average return. Should these assumptions break down in the real world of financial markets (as occurred in 2008), losses can potentially exceed the levels predicted by these mathematical frameworks.

Market Timing

The Traditional Strategic Allocator's "fix it and forget it" approach to asset allocation contrasts sharply with the approach of "Market Timers." Market Timers believe that they can predict the behavior of the market, and they alter the mix of asset classes within the portfolio based upon these predictions. The majority of market timers develop a proprietary approach to making these predictions, and consequently we can't make any general statements about how these predictions are developed. Market timing processes run the gamut from purely technical, to purely fundamental, to purely intuitive.

The Traditional Strategic Allocator maintains a static asset allocation strategy and therefore a relatively constant level of risk in the portfolio. The Market Timer, by contrast, seeks to increase or decrease the level of portfolio risk based upon whether their predictions are bullish or bearish toward a particular asset class. As a result, the potential gains and losses experienced by the client are entirely dependent on the accuracy of the Market Timer's forecast. Accurate predictions can potentially lead to strong returns, but if market predictions prove wrong, then the level of losses can be difficult to anticipate.

[1] For a more complete explanation of DSA, please see the February 3, 2009, *Strategic View –The Heart of the Riverfront Value Discipline: Dynamic Strategic Allocation,* which is available at www.riverfrontig.com.

The Riverfront Approach – Dynamic Strategic Allocation

At Riverfront, we have developed a new way of setting asset allocation strategy that we believe takes the best of these two approaches and combines them with our proprietary concepts and methodologies. Unlike the Traditional Strategic Allocator, we do not believe that market returns are random and unpredictable. Instead, we believe that careful analysis of historical returns reveals a strong relationship between the price paid for an asset and the subsequent returns investors can expect to earn over the next 5 to 10 years. Asset classes trading at below-average valuation tend to produce above-average returns, while overvalued asset classes tend to produce below-average returns. Put simply -- “Price Matters!”

Because we believe that the price paid for an asset matters, our return expectations, and therefore our asset allocation strategies, change as asset prices rise and fall. As a result, our strategic allocation models are dynamic, and our asset allocation strategy changes at least once per year as valuations fluctuate across the different asset classes. This longer term strategy is then modified with tactical tilts designed to accommodate current market trends. We recognize that undervalued asset classes can always get cheaper; therefore, when momentum turns against an asset class we make tactical adjustments to the allocation strategy in an attempt to protect client assets. Our largest allocations will typically be in those assets classes in which our sense of value and momentum are aligned, where the asset class is undervalued and the market is recognizing that undervaluation by generating positive price momentum in that asset class.

We believe that no investment process is infallible and that (to paraphrase John Maynard Keynes), “Markets can be irrational longer than [our clients] can be solvent.” Therefore, in contrast to Market Timers, we do not stake the investment success of our clients entirely upon either our “Price Matters” models or our tactical judgment of market momentum. Instead, similar to the Traditional Strategic Allocator, the Riverfront methodology uses client risk tolerance as an important driver of the asset allocation strategy, and clients with a greater capacity to absorb short-term losses have higher allocations to “risky” assets. To ensure consistency with client risk tolerance levels, tactical adjustments to the asset allocation are typically limited to between 5% and l0% of the portfolio. However, in contrast to the Traditional Asset Allocator, the asset allocation recommended for a particular level of risk will vary substantially over time based upon our DSA process and our Price Matters framework. In addition, since our risk measures also vary with the valuation levels (asset classes with higher than average valuations have higher than average potential for loss) we believe that our risk assessment provides better estimates of potential losses than the more static approach of Traditional Strategic Allocators.

Conclusion

As summarized in the table below, the assumptions and methodologies underlying the three asset allocation approaches described in this report are very different. As with so many aspects of investing, no consensus exists as to which of these three approaches is the “right” way to set asset allocation strategy. By understanding of the assumptions underlying the different asset allocation techniques, Financial Advisors can select the asset allocation approach that best aligns with their beliefs about markets and how they behave.

	Traditional Strategic Asset Allocation	Dynamic Strategic Asset Allocation	Market Timing
Guiding Principle	Efficient Market Hypothesis (Markets completely unpredictable)	"Price Matters!" (Markets "mean revert" over the long run in a predictable pattern)	Markets are predictable
Capital Market Assumptions	Expected return and downside risk close to long-term average levels	Expected return and downside risk change as asset class valuation levels rise and fall	Expected return predicted based on proprietary model
Primary Allocation Driver	Client risk tolerance	Client risk tolerance plus valuation levels of asset classes	Expected return of various asset classes
Allocation Strategy	Series of static "pie charts" tailored to specific risk levels	Series of dynamic "pie charts" optimized to both client risk tolerance and market valuation	Single allocation optimized to expected return
Risk Management	Correlation of asset classes	Tactical overlay and correlation of asset classes	Revised market predictions

Source: Riverfront Investment Group

Michael Jones, Chairman and Chief Investment Officer • 804-549-4801 • mjones@riverfrontig.com
Riverfront Investment Group, 9011 Arboretum Parkway, Suite 110, Richmond, VA 23236
www.riverfrontig.com