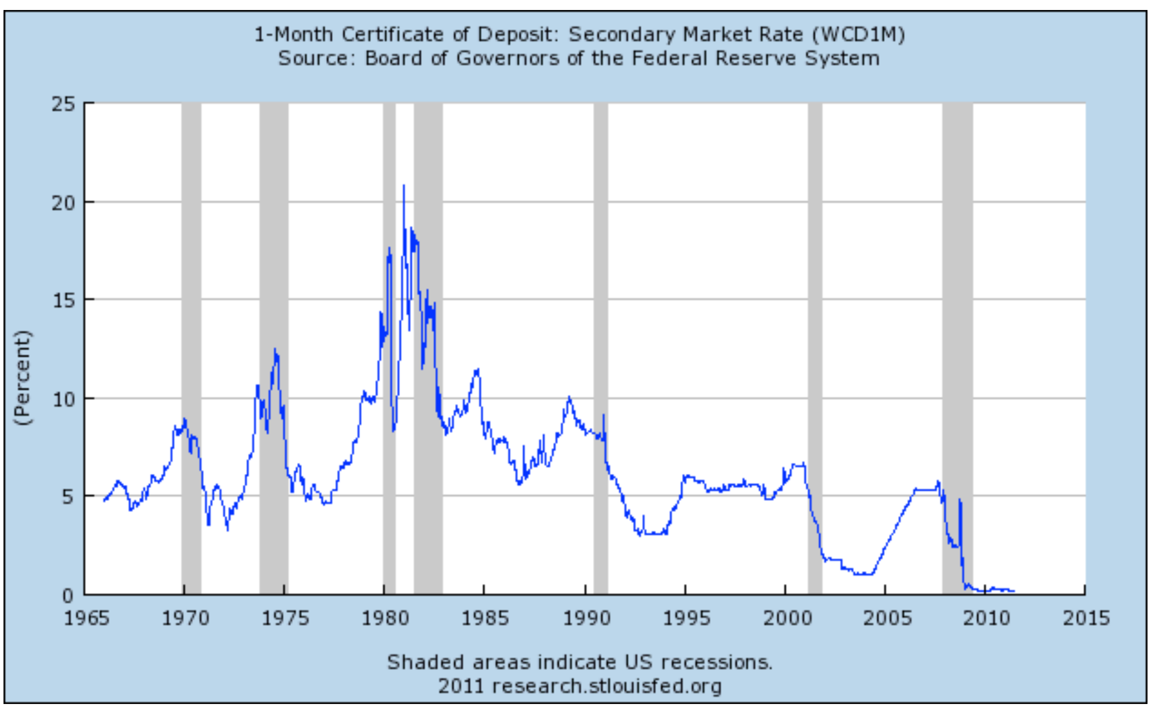
Sutton & Associates, LLC

If You Have Paper Assets...

(There Are Three Things you MUST Consider)

Over the past several years there has been a push the world over to exit paper assets and 'diversify'. Generally when you hear the word diversification, you immediately think of mutual funds and portfolios that are well balanced in terms of geography, industry, currency, economic cycles, and other types of factors. Until very recently, few people actually considered the idea that, despite all this 'diversification', their assets were all paper in nature. What would happen if the paper goes bad? Then 2008 hit with a fury and hammered paper assets, particularly stocks. Many people still haven't recovered. The push at the time to clear out of paper assets and into hard assets like gold and silver was a no-brainer for many folks.

However, nearly 3 years after Lehman, many people are struggling because they need income from what is left of their paper assets. Gold is a fantastic store of value, but its one genuine drawback is that it doesn't pay income; that is not its job. It is also neither feasible nor prudent to allocate 100% of your capital to precious metals. They are volatile and the last thing you need is to be stuck having to sell during a pullback. Meanwhile, banks are paying less than 1% per annum on most near term CDs and money market rates are in the tank as well. The unFederal Reserve has been doing its level best to fatten bank balance sheets by keeping rates in the basement. This allows your bank to pay you a mere pittance on your hard earned savings (capital) while allowing bankers to make mega profits by lending your money out 10 times over at an average of 15% credit cards. Even mortgages with historic low rates are profitable since the banks pay essentially nothing in interest.



Where does this leave savers? How about the retired couple, now empty nesters, but who still need money to pay their bills? Social Security is in trouble and hasn't given a raise in some time. Government inflation numbers are such that a raise is probably a long time coming. Many pension plans have ceased giving cost of living adjustments (COLAs) because there is little 'official' inflation. But you feel otherwise. You know better because unlike many of these bureaucrats, you actually have to make a budget work. You don't have your own printing press. In essence, you are forced into exposing yourself to the risk of the paper markets and hoping for the best. That just isn't good enough, nor should it be. If you must be in the paper markets, there are some things you need to know.

#1 Asset Selection is KEY

For the duration of this report, the following macro assumptions are being made:

1) The US Dollar is a wasting asset, and will lose value against real money (gold and silver). While the dollar may 'appreciate' as measured by the dollar index and other quantitative measurements, this is only because of the suffering of other currencies such as the Euro.

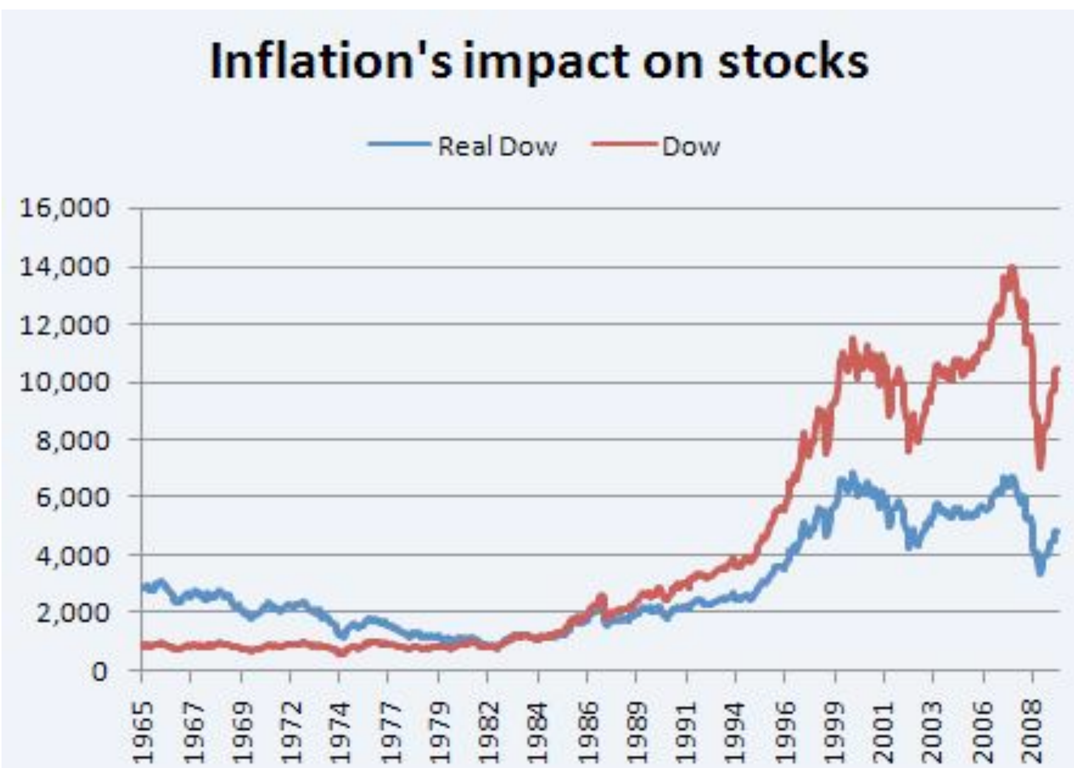
2) The USA is currently embroiled in an ongoing recession that policymakers have been unable to end despite trillions of dollars in runaway spending, borrowing, and in general a total failure to adhere to even the most basic of sound economic principles.

3) The above assumptions will act as a drag on US financial markets and economy, requiring policymakers to continue the near-zero interest rates that are relentlessly punishing investors such as you.

I have often sniped at mutual funds for excessive fees, loads, and surrender charges that are often not properly disclosed to investors before purchase. From a diversification standpoint, mutual funds are also NOT necessary. And from a risk management perspective, mutual funds can be an absolute disaster since managers are constantly shifting assets, yet holdings are often only reported quarterly. Closed End funds also offer some of these same challenges, particularly the fact that holdings can be changed at the whim of the manager without immediate disclosure to the investing public. One thing that I have found that I do like about CEFs, however, is the fact that their holdings are generally less complex than that of mutual funds. There can also be the opportunity to buy CEFs at a discount to net asset value with a similar potential to sell them at a premium should you want to divest.

That leaves us with several general classes of assets: common stocks, bonds, and a variety of 'special circumstance' securities such as preferred stocks, SIPs, ELKs, STRIPEs, and PINEs, among others. For the purposes of simplicity, I will be limiting the scope of this discussion to common stocks, preferred stocks (exchange-traded and otherwise), and corporate bonds.

The biggest negative of most common stocks is that they don't provide the income potential that is commensurate with their risk. In other words, if you're going to take the risk of losing half your money in the course of 6 months, as was the case in 2008, then you should be paid more than a paltry 2-3% yield for doing so. Common stocks are set up for the most part to have the majority of their returns come from capital appreciation rather than dividends. This is a nice idea - if it works. For the past ten years, that hasn't been the case. The Dow Jones Industrials is down 20% over that period when adjusted for inflation. So much for capital appreciation in our new economic paradigm. Many financial professionals and investors alike are still stuck in the 1980s in this regard when you could play pin the tail on the ticker with the Sunday business page and get a winning portfolio. Those days are long gone.



All that said, there are still some common stocks that pay a halfway decent yield - find them and check them out. I am not going to provide specific examples here since I don't have any information about the people who might be reading this report. **What you want are good basic businesses that provide things that are likely to be purchased even during a time of economic struggle and malaise.** Consumer staples are a good example of this. Things like food and personal hygiene products are good examples. Another benefit of consumer staples oriented companies is that their businesses are non-cyclical in nature so you don't have to worry quite as much about their stocks going through periodic downward swings as their business slows. Another good possibility is utility companies. Some bad examples would be firms that make high-end consumer discretionary items such as designer clothing, high-end electronics, and high-end home furnishings. Most stock trading platforms give you the ability to screen based on various criteria and you can select the sector(s) and set a minimum yield.

My three-part series on Basic Financial Analysis contains 18 pages of information on performing rudimentary analysis of assets and an important addendum on portfolio diversification. The addendum proves once and for all that you don't need exposure to hundreds of companies to be properly diversified.

A reasonable alternative to common shares is their preferred counterparts. The immediate drawback here is that not all companies who issue common stock issue preferred shares - in fact the majority don't. The positive side of these shares is that they generally exhibit very low volatility characteristics, which makes them ideal for the next section's discussion on risk. Another big plus is that the yields are generally substantially higher than those of their common counterparts. Imagine that - a higher yield for something that exhibits much less risk? I have built many of these portfolios for our clients that **feature risk profiles that are half that of the S&P500 and other major market indices while generating twice the income.** It must be said that with preferreds, you're generally giving up most of the capital appreciation potential, but to get paid 10X the interest the bank is paying is still not shabby. It puts you in a much better position to earn **a living rate of return** on your investment capital.

Royalty Trusts, Master Limited Partnerships and the former Canadian Royalty Trusts (most have now switched back to corporations) have also been candidates for many seeking above average dividend yields. Some of these securities have attractive risk/return profiles in that they provide a reasonable yield and the potential for capital appreciation. It must be noted though that these assets are generally more volatile - in some cases much more - than most major market indexes. This is not to say they shouldn't be part of a portfolio, however, moderation is the key. We'll talk more about this in the risk management section.

#2 The Asset Mix - Targeting Return

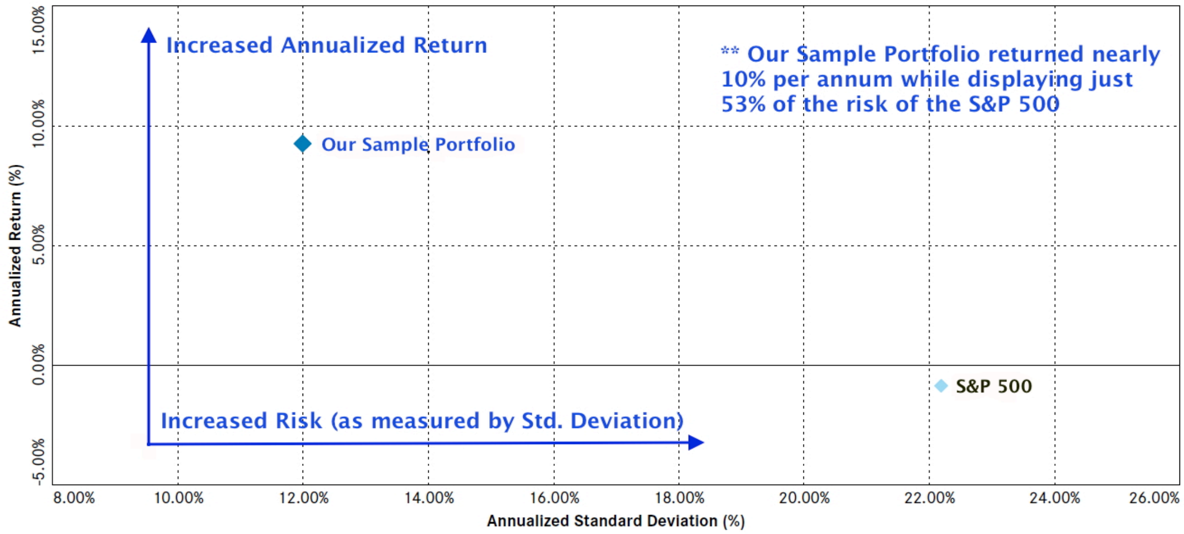
Let's say you sat down and figured out that you need a pre-tax return of 7% from your portfolio of $100,000 to provide you the income you need to meet your budget for the next year. You arrived at this number by looking at the growth in your household expenses, the growth in your other cash flows, and then adding taxes into your return equation. **This should be the first step you complete before you begin building a portfolio and certainly should be done before you start clicking the mouse and buying assets.**

Your portfolio is now all in cash, so you have $100,000 in investable assets. The 7% goal is not unrealistic at all, so what you want to do is figure out how to get it while taking the least risk possible. This is where the analysis can get tricky for the average investor. There are many specialized software packages that can be purchased such as MATLAB, StatPro, SmartFolio, and others that will do portfolio analysis for you and help you to determine volatility and form a risk profile. The downside is these programs are costly and take some degree of training and expertise before they can be used to their full potential. There are some free tools on the Internet that will do a very barebones analysis; a popular one is Kalengo. Beware that it is a community though, and make sure you set your profile's settings according to your willingness to share your portfolio!

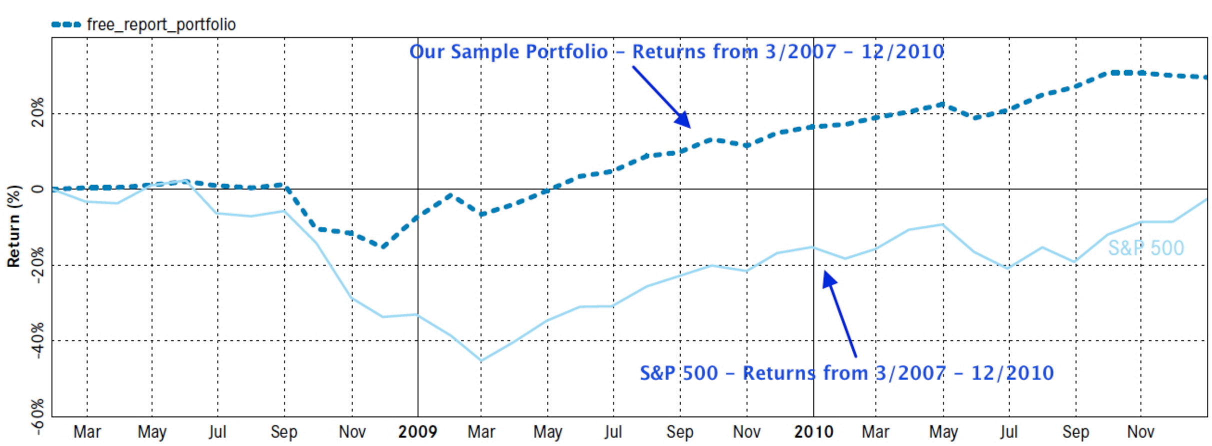
I will now take you through a portfolio optimization using SmartFolio, paying attention to the risk/return profile of our asset mix. Again, due to the fact that this is not specific investment advice geared towards an individual, asset identifiers will not be used, but the data provided does represent real securities. I will provide general information about each to give an idea of the makeup of the portfolio from a macro perspective.

Our sample portfolio consists of 8 individual securities. 4 of these are preferred shares, three of which are issued by utility firms and pay an average of 6% per annum in interest. The fourth preferred is issued by a multinational telecommunications provider and also pays around 6%. The remaining 4 securities are all closed-end income funds. Each focuses on corporate and/or sovereign bonds and almost entirely avoids US Government and Eurozone debt. These four CEFs pay an average of 6.7%.

Due to issue dates, we have data on the entire portfolio from 8/1/2007 through the present at our disposal for analysis so our period studied will be nearly 4 years. Those 4 years have been wrought with volatility so this should give us a rather good idea of the resiliency of our mix.



You can easily see that our sample blew away the S&P500 both in terms of return (9.53% per annum to -2.86%) and volatility as measured by standard deviation (11.99% to 22.25%) over the period from 8/1/2007 through the present. To be fair to the argument, the S&P500 did beat our sample in terms of return by 15.06% to 11.00% over the past year, but it did so by taking on roughly triple the volatility (5.88% for the sample to 19.26% for the S&P 500). The image below is a graphical representation of the side-by-side comparison of the sample with the S&P500 through 12/2010. **It is easy to see that our sample portfolio easily met our 7% pre-tax requirement established at the outset of the example.**



We can also see a bit more in terms of the weights of our assets and their overall contribution to portfolio risk along with their individual standard deviation metrics. The differences in Volatility are due to the fact that SmartFolio is using all data from 8/1/2007 to the current time whereas the two graphical illustrations are provided by iShares and only show data through 12/2010.

Names		Structure					
Asset Type	Symbol	Weights	Inaction Region Lower Width	Inaction Region Upper Width	Portion of Total Budget	Contribution to Portfolio Risk	Volatility
Portfolio					0%	100%	14.20%
Sort			Sort	Sort	Sort	Sort	Sort
Numeraire	Cash	0.00					
Asset		0.15	0.00	0.00	0.00%	10.21%	18.33%
Asset		0.15	0.00	0.00	0.00%	10.05%	14.41%
Asset		0.13	0.00	0.00	0.00%	13.60%	20.51%
Asset		0.13	0.00	0.00	0.00%	11.74%	20.66%
Asset		0.12	0.00	0.00	0.00%	14.40%	22.33%
Asset		0.12	0.00	0.00	0.00%	11.51%	22.61%
Asset		0.10	0.00	0.00	0.00%	14.47%	27.41%
Asset		0.10	0.00	0.00	0.00%	14.01%	29.14%
Factor	^GSPC	0.00	0.00	0.00	0.00%	0.00%	27.73%

Pay particular attention to the Contribution to Portfolio Risk figures. This is the amount of volatility that each component brings to the portfolio. The weights were adjusted accordingly to keep the contributions in relative balance. Obviously, by taking the weights to three or 4 decimal places, we could in theory make the weights equal, but since these figures change constantly as new price data are added, it is a pointless exercise. The fact is we were able to construct a substantially equal-weight asset mix which soundly defeated the S&P500 while having only one minor ‘down’ period during one of the biggest market blowouts in history. This is not a unique mix either; there are dozens if not hundreds of asset mixes that performed just as well.

#3 Risk Management is ESSENTIAL

The days of ‘set it and let it’ are also over. Portfolio management now requires constant vigilance even if actions are taken only sporadically. Separating the noise from the major themes is also essential. For example, markets have seesawed over much of the past two weeks due to the situation in Greece. One day markets are up big because the austerity plan may be passed; the next day they’re down big because some Greek politician says he might organize a group to block it. That is noise. The overriding theme is that the world is ridden with debt and that debt is going to cause problems. You need to be planning at a macro level based on the themes rather than trying to react to the noise. The former strategy will give you peace of mind and allow you to remain objective where the latter will cause impulsive action, poor decisions, and likely an eventual failure of your investment strategy.

Knowing what your asset mix will do in times of market distress is critical for developing an appropriate risk management strategy. Obviously for income-oriented investors, exiting the markets during turmoil may not always be appropriate. The good news is that if you have a solid, low-volatility portfolio, you may not have to exit the markets, but can continue to collect dividend and interest payments during market duress.

Risk management strategies can consist of actions ranging from exiting high volatility positions to complete exit to cash, to hedging with inversely correlated assets, inverse funds, options and other instruments. Generally, the risk management strategy needs only be as sophisticated as the investor. For the average self-directed investor, buying some put options or a quantity of an inversely correlated asset may be beneficial enough. For those investors who are working with portfolio managers, the strategies may increase in complexity. Some basic objectives should be:

1) Setting parameters in terms of what types of price actions or events need to happen to cause you to initiate risk management steps.

2) What are the objectives of your risk management strategy? Are you looking to remain invested to continue receiving dividends and interest? Do you have certain assets that you wouldn't mind 'losing' from your portfolio if markets begin falling? Are there tax implications to any of the above? These questions all need to be answered **before** you begin. Evaluating these questions periodically is also a good idea.

3) What types of actions are you comfortable with in terms of risk management? If you're self-directed, never undertake a strategy that you don't understand. You could very well end up exposing yourself to even bigger hazards than the ones you're trying to avoid. If you're working with someone, make sure they understand the strategy they're imposing on your behalf. Ask questions and demand answers. While it may be someone else doing the work, it is still your money and your responsibility to stay on top of things.

I hope that you've learned something from reading this report. My goal in writing it was to touch the surface of many of these topics in the interests of generating awareness of some of the challenges facing investors in terms of generating returns and portfolio construction. Unfortunately for us all, we live in a world of increasing uncertainty and this translates into challenges when looking at the assets we've been entrusted with. I built this firm on the idea that there was a lot being left on the table by mainstream economic and financial thought and set out to do it better. In pursuing that goal, we use an ever-increasing array of tools, proprietary econometric models, advanced statistical analysis, and financial simulations to battle harden both our client portfolios and those of self-directed investors alike.

My firm works with all levels of investors through a variety of means. For self-directed investors, we provide consulting services where we employ the techniques discussed above to assist in assessing and honing your portfolio. We also offer a paid newsletter that provides portfolio ideas and invaluable macroeconomic analysis from a diverse perspective. For those investors who desire portfolio management, we provide it on a non-discretionary basis. This means you are still involved in every decision that is made regarding your account and therefore are kept abreast of what is taking place. Given the stories of fraud and mismanagement by some of our peers, this is the only way we will operate when managing someone else's assets.

If I can be of assistance, please feel free to contact me directly via any of the means listed below and I'll be glad to speak with you about how Sutton & Associates can help you meet your financial objectives.

With Warmest Regards,

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