STATERA

ASSET MANAGEMENT

Commentary: July 2018

DUCK ON WATER

We attempt as often as we can to resolve many of the mysteries surrounding investment management and our version of it. Not always an easy task, as popular culture has left many with impressions far removed from the normal day-to-day activities that comprise our work. Rare is the frantic emotion suggested by cable financial news. Even rarer is agitated activity. By design, our work focuses on the client, who in our view generally doesn't benefit from any such bustle. Rather, our approach is founded on the idea that the client is best served when investing is approached with calmer hands and longer-term goals in mind.

Senseless Energy

While visiting with a client recently, we were asked at what time the investment team arrives to the office in the morning. In response, we instead suggested something on the order of, "before most everyone else, but after the market is open." The answer apparently left the client befuddled. How do we get done all the stuff that needs to get done in the morning? The advisor later explained to the client that, indeed, there was work to be done during the trading day, but not the sort the client had in mind.

Devoid of waving hands, green visors and even a display of garish ticker-tape cable financial news (blasphemy!), one is far more likely to hear morning hellos set against the comforting din of a coffee grinder than shouts to trade at the latest bid. Nonetheless, readers should not read a lack of gravity in the ostensibly twee setting. Built into our approach is a seriousness that places client investment outcomes and overall experience above such methodological madness.

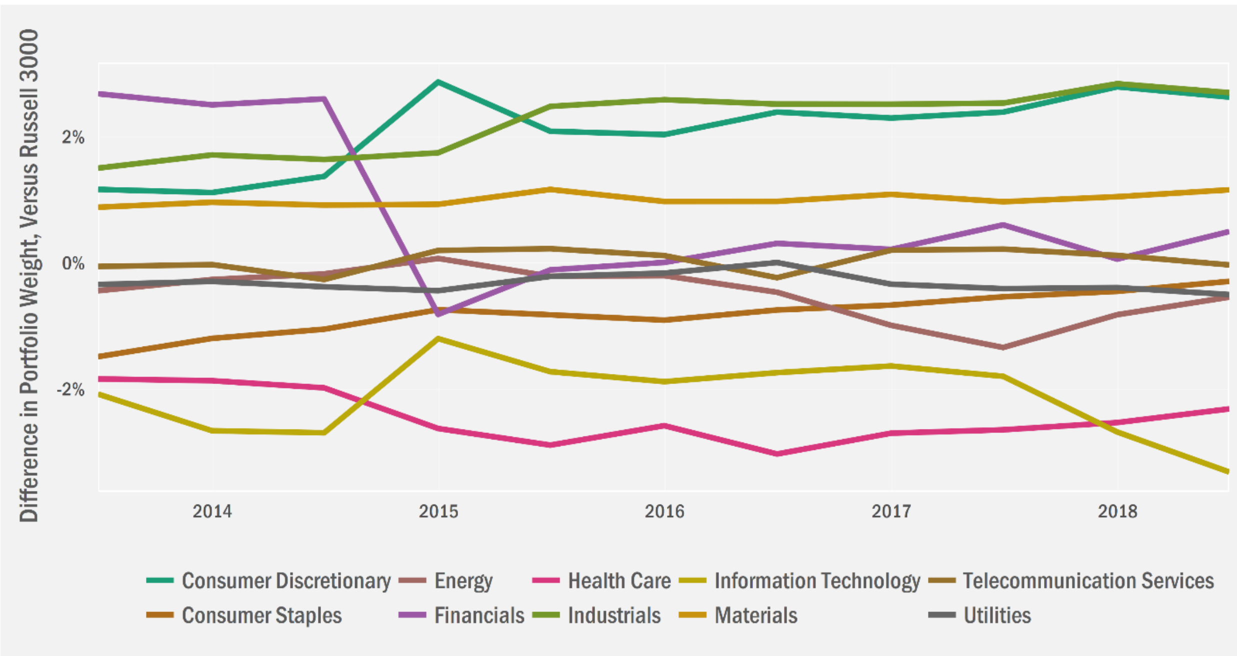
We're rather sure that generic big-screen portrayals of trading rooms have set the stage for folks thinking our offices are a frenetic zoo. Perhaps the source of the sense of "required drama" may be the idea that more is better. That more trading and more emotion should add up to greater performance…more success. On the contrary, whether due to increased trading costs, higher annual tax bills and/or in-hindsight poor investment decisions, greater activity doesn't seem to equate to better outcomes. Instead, we believe clients are best served via an approach that seeks to align financial goals with an investment allocation targeting a relative return/risk assumption appropriate to the time horizon(s) related to those goals. The thinking necessarily leads to an investment approach that similarly focuses on longer-term intentions rather than daily tasks.

We generally don't trade our models on a daily basis, because we designed them such that we don't need to. That does not mean, however, that our models are static. Much like the fluttering feet that propel a duck with relative grace above the water, immense activity occurs beneath our generally steady list of investments. Still, the lack of *visible* activity does not mean we are not in the pursuit of better outcomes. Quite the opposite, we believe a calmer approach is key to a methodology that seeks improved investment performance against the backdrop of a more favorable client experience.

Portfolio-Specific Examples

Readers already should know that our model design includes intentional tilts toward investment factors understood historically to have provided incremental gains versus the broader market, thereby suggesting the potential to do so in the future[1]. What's relevant to know about these factors is that their expression in individual stocks can change over time. That is, stocks that can be considered Value (relatively less expensive versus other stocks in terms of price relative to corporate fundamentals) today might not be Value (or small or more profitable) next month. To maintain the tilts, then, portfolio holdings generally also must change. But, there's a balance to be maintained: for every incremental shift in present exposures we may desire to make, we must weigh the costs of achieving that exposure.

Figure 1: Example Fund Deviation from Market Sector Weights



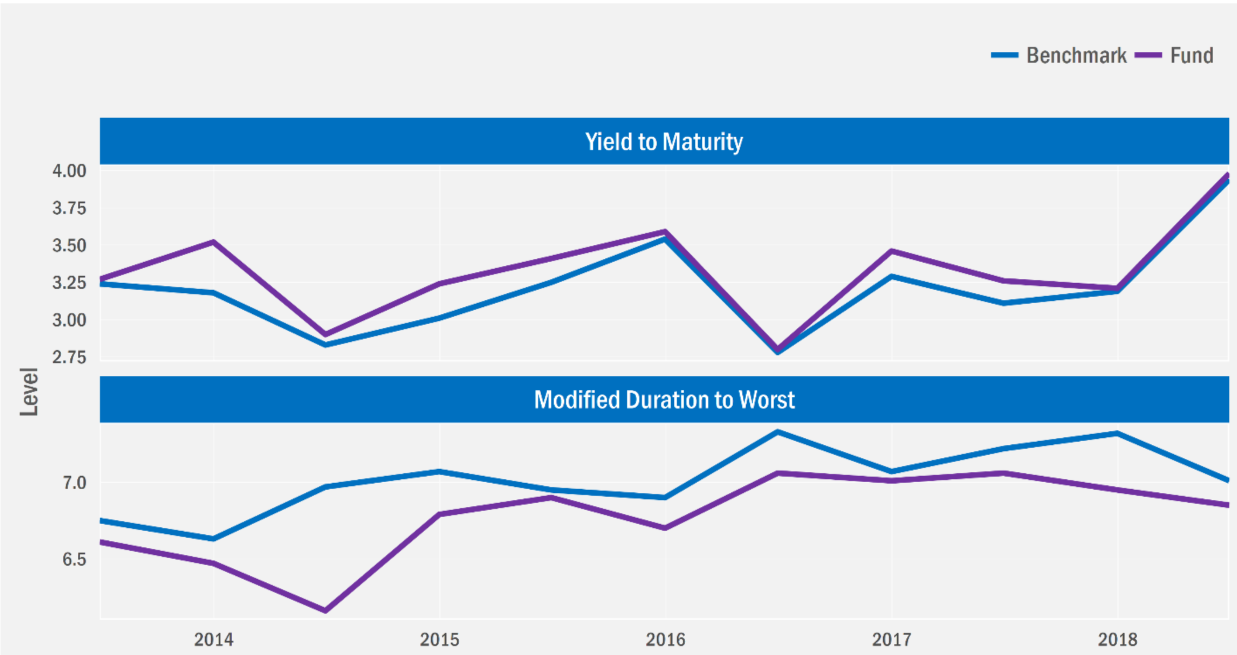
From 06.30.13 to 06.30.18. Data are for one equity mutual fund presently utilized in model portfolios. The holdings of individual funds, the weights of funds in the models and the differences in sector allocations within specific funds and across funds relative to any benchmark are subject to change. SOURCE: Bloomberg

Such decisions generally are not daily work for our Investment Team, however, as they far more often occur beneath the surface of our individual fund holdings. For example, we do not use a "top-down" approach to "pick" sectors as part of our investment process. Sector biases versus relevant benchmarks nonetheless may result from shifts in the portfolio as a result of the "bottom-up" evolution of the underlying characteristics of the individual stocks the funds own. To show what we mean, in Figure 1 we have charted longer term shifts in the underlying sector exposures of one of the equity mutual funds in which we invest, displaying the relative weight of each sector in that fund (fund weight minus the benchmark weight of each sector). The chart shows relative movements in sector weights, versus the benchmark, all of which would have occurred within the fund and without obvious change being seen at the model level (e.g. swapping of one fund for another).

[1] For a refresher, readers may look to our March 2017 commentary.

Similarly, we believe there is potential benefit to managing fixed income exposures in a manner that acknowledges the state of the broader interest rate environment. When the expected potential additional return from a potential shift may warrant accepting additional fixed-income-related risk[2], we may seek to adjust portfolio exposures. Here, again, our desire for a more efficient approach has led us to focus on a relatively narrow set of investment funds, characteristics for one of which we present in Figure 2.

Figure 2: Example Fund Deviation from Market Characteristics



From 06.30.13 to 06.30.18. Data are for one fixed income mutual fund presently utilized in model portfolios. The holdings of individual funds, the weights of funds in the models and the differences in aggregate characteristics within specific funds and across funds relative to any benchmark are subject to change. SOURCE: Bloomberg

Relative to a benchmark that represents the investment opportunity set of that fund, we can see from the data that fund exposures have changed through time, according to a methodology that the manager believes may generate incremental benefit in terms of performance relative to that benchmark.

Both pictures show portfolios that change over time and that maintain a composition distinct from the broader market. Though the approach may not always be successful, we believe these distinctions can add to long-term performance, versus the broader market. And the maintenance of those distinctions, we also believe, is most efficiently pursued via the present design of our investment methodology.

[2] Readers may revisit our January 2017, February through April 2018 commentaries for a review of risk in fixed income.

Easy to Make Bad Soup

The natural next question is what value does Statera bring to the mix? Perhaps another metaphor works here: it doesn't matter how grand a pantry one keeps…it's still easy to muck up a soup. We established our investment methodology first, then regularly revisit the list of those individual funds via which to execute that strategy. Again, as part of our process, we choose to tilt models to investment characteristics understood to have provided incremental benefit over passive market exposures in the past. We seek to achieve those tilts in as efficient of a manner as possible, including both the activity that exists within the funds and the trades that Statera executes at the model level.

Sifting through the potential investment opportunity set[3] takes not only time, but also precise purpose, along with a substantial amount of math. The math is defined by a statistical approach that first seeks to collate individual funds into baskets of risk-focused exposures. We in turn review backsets of funds that pass various levels of analysis in order to develop what in our view are optimal models for a given level of appetite for risk. The process—which is ongoing, as the list of potential investments continues to evolve—further involves direct discussions with various fund managers in order to ensure that, for example, past fund data and detail are reflective of what we may expect from those funds in the future.

In practice, our Investment Team could seek to incorporate the entire range of desired exposures (and shifts in those exposures) in our models. But, to be very candid, the scale required to efficiently implement such exposures, all costs considered, is far beyond that maintained by most investment managers such as Statera. In fact, we believe such pursuits require an enormity not achievable outside of the relatively more specific businesses operated by mutual fund and exchange-traded fund (ETF) providers. Their managers' experience, expertise, scale and efficiency we have no need to match, happily, given the relative ease via which we may integrate their funds into our target models. Even so, these fund managers are only suppliers of raw materials. SRCM, in turn, utilizes those raw materials to assemble the models within our Global All Asset Series, solutions we believe are appropriate to a wide range of individual client investment situations.

More Time for the Better Focus

Our investment methodology seeks to provide purposeful mixes of asset class exposures within a series of models, each of which is purposefully designed to present a specific prospective relative risk/return context to clients. To achieve those goals, we utilize a disciplined approach to parse the breadth of potential investments available to determine those funds that most efficiently express the investment characteristics we desire. In the end, we believe this approach fits best with the interests of clients and our efforts to facilitate the pursuit of their financial goals.

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[3] In its 2018 factbook, the Investment Company Institute recorded 7,956 mutual funds and 1,832 exchange-traded funds (ETFs) available for investment in the United States. Not counted in either group were funds that invest primarily in other funds.

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