



# Rebalancing in a Volatile Market

By: Scott S. George, Chief Investment Officer, Mason Investment Advisory Services, Inc.

For those of you who read my October 2008 letter to investors, you may recall that our view about market corrections is that they run in irregular but inevitable cycles, each caused by completely different triggers. We cautioned that the timing and magnitude of each correction seems to be predictable only in hindsight. As we now know, markets had much further to fall. Most stock markets reached their low points on March 9, 2009 a full 55.2% from the peak valuations in October 2007, as measured by the Dow Jones Total US Stock Market index.

Another important message in my October letter was that we believe that it is important to maintain a disciplined long term plan that balances the competing goals of risk management and return expectations. Further, we stressed to our clients and others that a detailed asset allocation plan combined with a disciplined rebalancing process may allow us to use market volatility to our advantage. For the first six months of 2009, our portfolios have posted positive returns, with many of the asset classes within the portfolios contributing double digit returns.

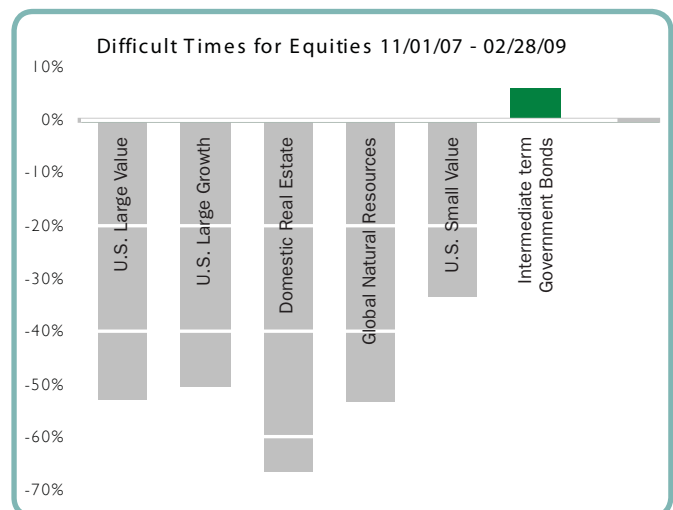
What have we learned? What is our plan, going forward? As an investment advisory firm with a long tradition that is steeped in a disciplined and consistent investment philosophy, it is interesting to note that during times of extreme panic and euphoria maintaining our investment discipline can be a challenge. It is our belief that this discipline has seemed to be the right course of action again, as the following points illustrate:

## Asset Allocation Does Work

By the end of first quarter 2009 we occasionally read in the financial press, including some of the professional journals, the pronouncement that “asset allocation did not work this time,” and some firms stopped rebalancing altogether. Some said they would wait until the markets “settled down.” We disagree with those ideas. We believe that it is prudent for long term investors to have a time horizon of at least five to ten years. Most of our clients have horizons well beyond ten years. It appears that the conclusion drawn by some in the press was based upon six to nine months of data – which does not seem to be a rigorous method for testing the validity of any long term investment strategy.

It is true that from the market peak in October 2007 through February 2009 every single tradable liquid equity category in the world was down between 33% and 66%, as measured by the Morningstar Mutual Fund Category Averages.

Equities tend to be a good leading indicator of the economy and these declines foreshadowed a deep recession. However, the extent of these declines was further influenced by a combination of liquidity needs caused by a freeze in our financial system and perhaps by investor panic. These were purely macroeconomic forces that resulted in prices for stocks that bore no relation at all to their values. As of this writing, stock valuations, while still low by historical standards, are



becoming more stabilized. As one of the portfolio managers of a third party mutual fund that we recommend to clients stated in its most recent annual report, “the process of fundamental company investment research feels relevant again.”

We have always stressed the importance of a meaningful bond allocation, even for a growth oriented portfolio. This importance was never more evident than during the recent stock market correction. Since bonds declined less than equities, they reduced the amount of downside risk in our clients’ portfolios. In addition, bonds provided us with an asset class to sell so that we could take advantage of the extremely devalued equity categories in our allocations. Again, we followed our disciplined approach and continued to rebalance our portfolios.

## Importance of Rebalancing Strategy

Rebalancing policy is a key component of our asset allocation strategy. Quite simply put, we want to buy low and sell high. With up to 16 asset classes in our portfolios, there are many moving parts that provide us with opportunities to take advantage of volatility. As a further advantage, we have technology that allows us to review each of our portfolios on or about every 10 business days while many in our industry review portfolios quarterly or even less frequently. This does not mean that we are creating transactions every two weeks; rather, we are increasing the probabilities of capturing prime opportunities to rebalance. Our current policy is to buy or sell back toward target when an asset class moves 20% beyond its strategic target.

How did our rebalancing triggers affect our managers and our portfolios during these volatile times? We have initiated more rebalancing changes over the last year than any other in our history. Let’s look at a couple of asset classes to illustrate the rebalancing effect.

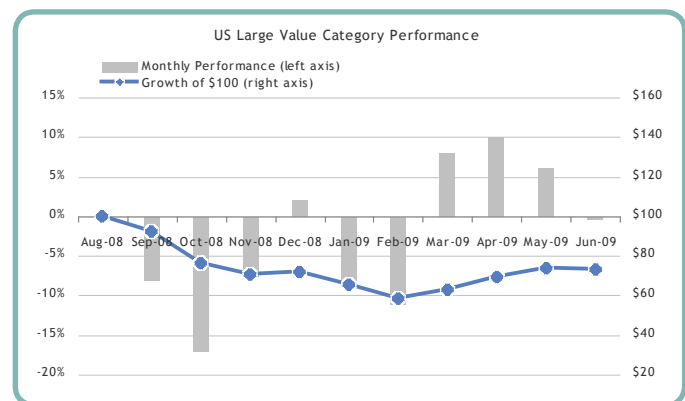
## Large Cap U.S. Value Category Average as Reported by Morningstar

In September 2008 this asset class lost 8.3%, followed by losses of 17.1% in October and 7.6% in November. There was a brief respite of a positive 2.3% return in December, only to be punished by a loss of 9.3% in January and 11.3% in February. March 9th, as of this writing, was the bottom of the market. Just when some investors were contemplating drastic changes to their portfolios including liquidating in favor of cash, this asset class came back with positive results of 8.5% in March, 10.1% in April and 6.4% in May. While June’s results showed a loss of 0.4%, the year to date performance of this asset class was a positive 1.9%. We have found that our rebalancing discipline has enhanced these returns during the first six months of 2009.

As an example of how rebalancing worked so far this year, let’s review the performance of a large cap fund we have recommended to clients for many years,

Davis New York Venture<sup>†</sup>. A buy and hold strategy

for this fund, year to date through June 30, 2009 would have produced +6.5% - a good showing versus the category average of +1.7%. However, due to our rebalancing reviews triggering additions to this mutual fund, the weighted average performance for our clients in our Growth and Income portfolio (or our Mason “C” portfolio) holding Davis New York Venture was 13.8% for the same period or an additional 7.3% return.

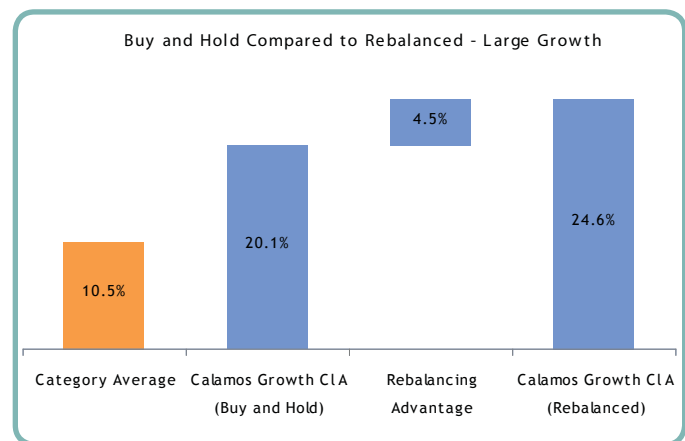
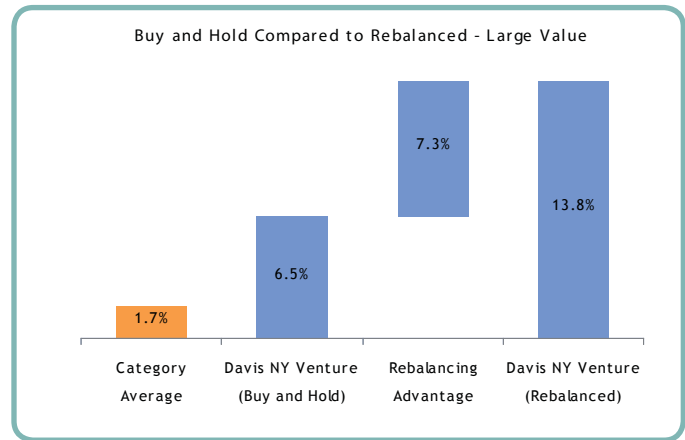


<sup>†</sup>Please note that the examples selected for this discussion were chosen to show the potential benefits of rebalancing. During the period studied from January 1, 2009 to June 30, 2009 we tested the 38 mutual funds currently open on our approved list. Of the 38 mutual funds, 28 performed better due to rebalancing and 10 performed worse. Of the 28 that performed better, the range was +0.01% to +24.11%. Of the 10 that performed worse due to rebalancing, the range was -0.25% to -4.55%. In addition, please note that 6 of these 10 were fixed income managers that were rebalanced into higher performing equity managers.

### Large Cap U.S. Growth Category Average as Reported by Morningstar

Through June 30, 2009 the year to date category average of this asset class was 10.5%.

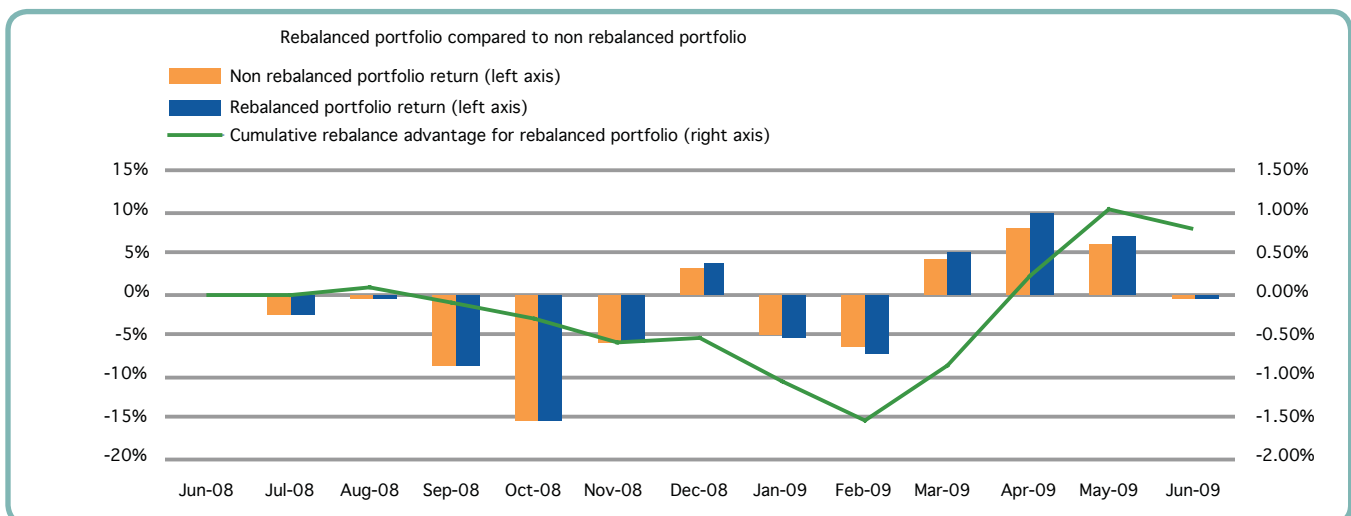
The Calamos Growth fund, another fund we use in our clients' portfolios, returned 20.1%, much better than the category average. Was there any advantage with our rebalancing strategy? Again, due to our rebalancing reviews triggering additions to this mutual fund in our "C" portfolio, our client's weighted average return in this fund was 24.6% for the same period or an additional return of 4.5%.



### Portfolio Level Rebalancing Benefit

Rather than show additional asset classes and managers where rebalancing was positive, we analyzed rebalancing at the portfolio level for the 12 months ending June 30, 2009. We created two model portfolios with our "C" allocation targets and our current list of approved managers. Portfolio 1 was not rebalanced and was allowed to drift over the 12 month period while Portfolio 2 was reviewed for rebalancing opportunities every two weeks beginning June 30, 2008. One of the key points is that while Portfolio 2 was reviewed every two weeks, it was rebalanced only when an asset class violated our predefined 20% rebalancing bands. So, how did these portfolios perform? Over the 12 month period, the rebalanced portfolio outperformed the "no rebalance" portfolio by nearly a full percentage point at 0.79% or 79 basis points.

We believe you should have a clearly defined asset allocation strategy and you should follow the discipline of a clearly defined rebalancing strategy. It is our opinion that you should not try to time the market. If you are out of



balance when the market changes direction, you may be over or under exposed to that particular market swing. We believe that these results show some of the benefits of rebalancing.

## The Importance of Manager Selection

We have been reminding our investors that there is a big difference between downside volatility and permanent loss of capital. Concentrations in securities of a single company or industry sector can lead to a permanent loss of capital, but the probability of this occurring in a diversified asset allocation is greatly reduced. During the market correction from 2000 to 2002, the more successful equity mutual fund managers tended to outperform their indices because of good stock picking. During that correction, stock declines concentrated more on some of the “technology” stocks that in hindsight were tremendously overpriced, or whose main customers were other companies about to go out of business (poor earnings quality). In addition, as index funds attracted more and more investor dollars and were tracking indices that are market capitalization weighted, they were required to continue to buy these stocks regardless of fundamentals causing them to become a larger and larger part of the index and the equity markets. We believe that a good active portfolio manager has a chance of avoiding many (but not all) of these pitfalls.

This latest correction was much different. As mentioned previously, all equity categories plunged dramatically, caused in part by indiscriminant selling. Our thesis in the first quarter of 2009 was that, even though active managers performed as badly or worse than the indices this time, they may have a chance of recovering faster because the more successful active managers have a tendency to choose companies that are of high quality.

We are beginning to see strong evidence that this thesis is valid as we compare the returns of our active large cap managers to their indices year to date through June 30, 2009. For example, our mix of active managers in Large Cap Value US outperformed the Russell 1000 Value Index by over 5%. Our Large Cap Growth US managers outperformed the Russell 1000 Growth Index by over 3%. On the international side the results were even more interesting to us. Our mix of managers in International Large Cap Value and International Large Cap Growth outperformed the MSCI EAFE by 5% and 7% respectively.

## The Risks of Market Timing

Back in October of 2008 we warned our clients and others that, although we cannot predict how far the market would fall or for how long, staying invested in a portfolio strategy and overcoming the temptation to time the market was essential. Although we noted that peak to trough to peak (getting back to peak valuations or getting back to even) could take anywhere from one to seven years, historically, the positive returns coming out of a correction have been large and compressed into short periods. If an investor missed those short periods, he or she may dramatically extend his or her recovery time. This recent recovery has been no different. Equity returns for the second quarter of 2009 as measured by the Dow Jones U.S. Total Stock Market index, were 16.8%. If an investor was out of the market during those three months, he or she missed that part of the recovery. The Mason “C” composite, a mix of approximately 65% equities and 35% bonds and cash, had a positive 15.9% return for the same period.

## Is this Market Recovery Legitimate?

Each day there is uncertainty going forward. This is always true, though we do not always remember it. We believe that attempting to predict the direction of the stock market in the short term is nearly impossible and, more importantly, dangerous to success as an investor. As we have tried to show above, discipline in sticking with a well planned strategy is what we believe will increase the probabilities of investment success over time.

One of our favorite small cap value stock managers is currently enjoying picking stocks in an environment where corporate bond yields average in the high single digits, while earnings yields on their stock picks average in the

mid-teens – and this during a recession. Again, as we pointed out above, there is a big difference between interim low valuations and permanent loss of capital. This does not mean there are not market forces that could rattle the nerves of investors again at any time. Macroeconomic events caused many quality stocks to become severely undervalued by March 9th, and those types of forces could occur again. If we see these types of low valuations again, our approach may allow for a greater opportunity to take advantage of the indiscriminate selling of others. By having a well thought out plan and the discipline to follow it, long term investors should benefit once again.

Scott S. George  
*Chief Investment Officer*  
Mason Investment Advisory Services, Inc.

## Important Disclosures: Mason Composite (C)

Mason Investment Advisory Services, Inc. "MIAS" recommends asset allocation strategies for each client based on their investment objectives. Performance information presented on the previous page reflects the actual investment performance of MIAS' "Moderate (C) Asset Allocation Composite"; also referred to as MIAS' benchmark "C" Composite.

This portfolio is a starting point for designing strategies appropriate for clients with moderate risk tolerance. We are presenting this performance information to illustrate actual historical performance where MIAS has developed and implemented the investment strategy using our recommended managers and funds. Performance of the MIAS Moderate (C) Asset Allocation Composite is presented net of all investment management fees, transaction costs and other expenses. These fees have not been deducted from the index performance used for comparison. **Past performance does not guarantee future results.**

The following disclosures describe our composite compilation methodology.

Portfolios included in the performance composites are screened for the following criteria:

- Asset class percentage targets (i.e. Safety, Income, Growth & Aggressive) must be within 2% of the model portfolios' targets
- Category target (i.e. US value, US growth, short term bonds, etc.) percentages must be within 3% of the model portfolio's targets
- No less than 95% of assets must be invested in managers and funds approved by our investment committee for use in our allocation strategies (not including Treasury securities)
- Portfolios must be rebalanced regularly in accordance with Investment Committee policies
- Portfolios that satisfy the above constraints at the time of calculation are included in the composite

As of June 30, 2009, MIAS had a total of 705 client accounts including discretionary and non discretionary accounts. Of these, 507 client accounts were included in one of five MIAS composite portfolios. Those not included in any composite were custom allocations that did not meet one of the above criteria.

Portfolios that satisfy the above constraints at the time of calculation are included in the composite

Number of accounts in the Moderate (C) Asset Allocation Composite returns as of:

December 31, 1999:.....	6 accounts
December 31, 2000: .....	9 accounts
December 31, 2001:.....	12 accounts
December 31, 2002:.....	48 accounts
December 31, 2003:.....	89 accounts
December 31, 2004:.....	132 accounts
December 31, 2005:.....	180 accounts
December 31, 2006:.....	234 accounts
December 31, 2007:.....	268 accounts
December 31, 2008:.....	287 accounts
June 30, 2009: .....	294 accounts

Composites are a mix of taxable and municipal bonds.

Composites are a mix of mutual fund only portfolios and portfolios with private money managers.

Composites are a mix of discretionary and non-discretionary accounts.

Composites may include limited partnerships. Valuations are estimated by the general partners.

Composite return calculations are net of all investment management fees, transaction costs and other expenses.

Dividends and interest on mutual funds are reinvested and results displayed reflect that reinvestment. Dividends and interest on all other securities are reinvested irregularly, as cash accumulates and results displayed reflect that reinvestment.

Many clients of Mason Investment Advisory Services, Inc. have experienced the returns illustrated in the accompanying charts, net of all investment management fees, transaction costs and other expenses. The objectives of the benchmark "C" composite portfolio are to provide returns that cover spending and keep pace with inflation (preserves purchasing power). There is a secondary objective to ensure stability of the payout.

**Note: In 2009, we switched our method of composite calculation from internal rate of return to time-weighted rate of return. All returns in the attached document(s) are calculated on a time-weighted return basis.**

The term "time weighted rate of return" is defined as a calculation that computes period-by-period returns on an investment and removes the effects of external cash flows, which are generally client-driven, and best reflects that firm's ability to manage assets according to a specified strategy or objective. The time-weighted return method of composite calculation differs from the internal method of composite calculation. For all clients who have been eliminated from the composite, time-weighted return calculations will incorporate their returns for all time periods prior

to their elimination from the composite. (Internal rate of return [IRR] calculations do not incorporate clients who have been eliminated from the composite for any time period. Only clients who were in the composite for the entire period are included in IRR calculations.) Also, time-weighted return calculations seek to minimize the effects of cash flows on a portfolio's return, whereas IRR calculations may be significantly impacted by the timing and size of cash flows. The time-weighted return method of calculation used by MIAS is an industry accepted method of comparing a portfolio's return to reference points such as indices and/or manager universes.

MIAS composite portfolios contain a number of funds and/or managers in some or all of the following categories:

**Cash:** This includes taxable and/or tax exempt money market funds

**Bonds:** Composite portfolios may include managers and/or funds broadly classified as short term, intermediate, and/or long term bonds. These may include a mixture of taxable and tax exempt bond managers and funds. Additionally, composites may include allocations to funds investing in foreign bonds with both hedged and non-hedged holdings, as well as inflation-protected bonds.

**Equities and other more aggressive investments:** Composite portfolios include allocations to domestic large cap value and domestic large cap growth equities as well as foreign large value and foreign large growth equities which are held through mutual funds and/or separate account managers. Additionally investments in real estate related equities are included in underlying investments of the composites. The composites also hold investments in equities we classify as domestic small growth and domestic small value as well as those we classify as aggressive international which consists of investments which hold equities of smaller foreign companies as their primary investments. Finally, these composites include investments related to energy and natural resources. These include both equity investments and investments tied directly to underlying commodities contracts.

Over the 10-year period, there was a change in the asset allocation in which we removed the asset class of "equity income", as it was already reflected in another asset class titled "large cap value".

Over the 10-year period, we added "international small caps" to our asset classes.

In 2001, we removed the "emerging market" asset class allocation from the "C" portfolios.

As of December 31, 2008, there were approximately 48 money managers on our approved list. As of December 31, 2008, the average change of money managers since the inception of the MIAS C composite was 7.76%. Since 1998, when we began tracking manager turnover, approximately 25.58% of manager changes have been due to a change of management within the fund. The balance of manager turnover was for reasons such as underperformance or style drift.

In 2006, we decreased our allocation in Cash and Cash Equivalents.

In 2006, we increased our "energy and natural resources" allocation and changed the title of this asset class to "energy, natural resources, and commodities".

In 2009, we added inflation-protected bonds to our asset allocation.

In 2009, we decreased our allocation to short-term, intermediate-term, and long-term bonds.

In 2009, we decreased our allocation to US large cap growth.

In 2009, we increased our allocation to foreign large cap value and decreased our allocation to foreign large cap growth.

In 2009, we increased our allocation to small cap value and decreased our allocation to small cap growth.

In 2009, we changed our method of composite calculation from internal rate of return to time-weighted rate of return.

**Investment return and the principal value of an investment will fluctuate. An investment may be worth more or less than original cost when redeemed. Current performance may be lower or higher than performance shown.**

The choice of time period illustrated substantially affects the results and, thus, the conclusions to be drawn by the investor.

Some of our accounts are not included in this composite because they were custom allocations that did not fit any of our above-listed criteria.

The composite reflects the results of only those clients who followed our above-listed criteria.

For those accounts not included in the composite the investment results were likely different from the composite results.