Fund Architects

Building Modern Portfolios Beyond Theory

Q & A

Daniel Snover
Vice President & Deputy Chief Investment Officer

Portfolio manager Daniel Snover thinks his new Blueprint Portfolios may have actually conquered the Efficient Frontier.

Consistent with the firm's stated goal of "**delivering an improved client experience**," Fund Architects has recently introduced a series of separately managed accounts **– the Blueprint Portfolios –** that attempt to maximize the benefits of diversification.

According to Mr. Snover, who also serves as Fund Architects' Deputy Chief Investment Officer, the way the firm sets out to improve an investor's risk-adjusted returns these days is "different than that of the other active manager."

For more insight into the Blueprint Portfolios and the TrueDiversification process, we sat down with Mr. Snover to get his thoughts on what might be the 'Holy-Grail' of portfolio construction

FUND ARCHITECTS
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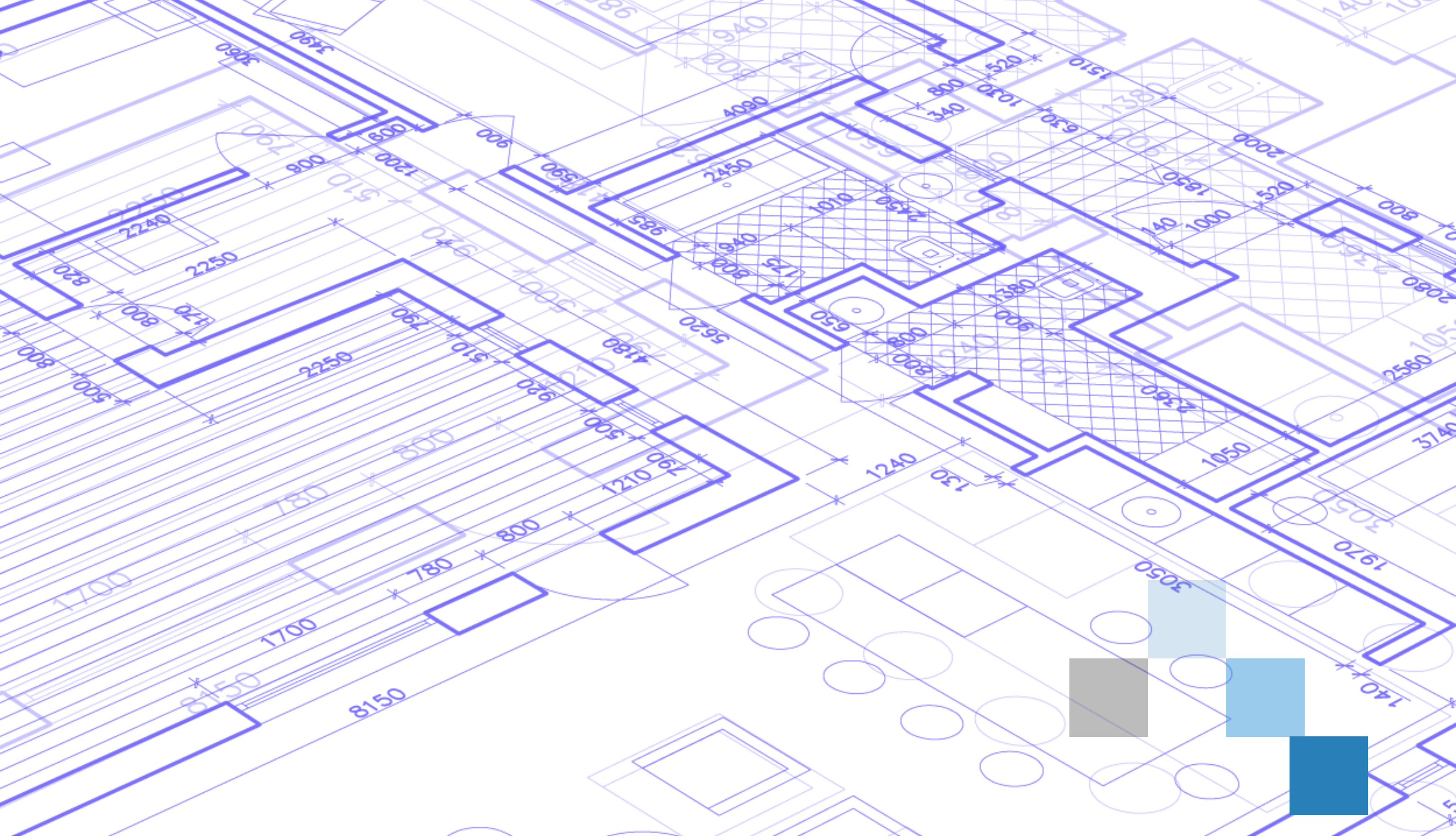

In a nutshell, what is a Blueprint Portfolio?

Daniel Snover : The most straightforward answer is to say that the Blueprint Portfolios are asset allocation models done in a way that maximizes diversification.

Didn't Harry Markowitz popularize that idea back in the Fifties?

He did indeed. In fact, he won a Nobel Prize in Economics for his Modern Portfolio Theory, which he proposed in 1952. Essentially, Markowitz put forth the idea that investors should seek the highest possible risk adjusted return, and you do that with the benefits of diversification. Asset allocation models were initially imagined to hold small percentages of many different asset classes and expect, or hope, those assets provide diversification.

Are you suggesting asset allocation models don't necessarily maximize diversification?

I am. But not because Markowitz's math was off. It wasn't. Markowitz only provided a framework for making decisions, not a real-world investable solution. Other managers use long-term averages to calculate MPT's most important inputs: risk, returns, and correlations. Then, they set static targets and hold them over time. The industry has been following this path for years even though it has not proven effective.

"We're practicing Modern Portfolio Theory in a more modern way"

Sounds like the Blueprint Portfolios do not follow that path...

They do not. We started with Markowitz's idea that investors are risk averse, and diversification should be used to lower risk. Although instead of relying on long-term averages to set allocations, we're building portfolios that continually reflect the realities of an ever-changing global market. We like to think we're practicing Modern Portfolio Theory in a more modern way.

Don't all, or at least most, asset allocation funds do that?

Hardly. Traditional allocation funds can't diversify away the risk that the market crashes. This is because the correlation between different asset classes occasionally moves toward one.

And that means what?

It means that asset classes start moving in the same direction. So instead of providing varying sources of return, they're providing very similar returns. Going down at the same time, in other words. The most out-sized example is the Financial Crisis, when classically non-correlated assets like equities, real estate and commodities fell at the same time, but the condition happens on a smaller scale fairly often.

The result is that traditional asset allocation models are unable to provide the intended diversification benefits when they're needed most. Worse, because these models are forced to hold under-performing assets for the sake of diversification, they also lag during market rallies.

So, investors can lose on both the growth part of their portfolio and the protection part as well?

Regrettably enough, yes. It's traditional diversification's downside danger. We developed the TrueDiversification process for the Blueprint Portfolios to solve, or at least make a good effort toward solving, this failing of traditional diversification.

Sounds like a big leap...

It is, but not so much in theory as it is in execution. It's our position that effective diversification comes not from the number of positions that are held, but from the current correlation of the underlying positions.

Correlation, or lack of correlation, is what creates diversification. We like to say that markets change, your allocations should too.

And that's how we designed the TrueDiversification process -- to maximize the benefits of diversification by continually targeting a portfolio with the optimal risk, return, and correlation metrics.

So TrueDiversification... Is it different from what everybody else thinks of diversification?

It's still diversification, but it's just done in a way that we think is a lot more efficient than the old model. Instead of buying and holding small percentages of many asset classes, we're looking to identify the top asset classes in the current environment that, when combined, will represent the highest risk-adjusted portfolio.

To get there, the TrueDiversification system starts by analysing a defined list of broad asset classes, including U.S. large-, mid-, and small-cap stocks, European large-cap stocks, emerging markets, U.S. long-term treasuries, U.S. real estate, gold, and cash.

How do you determine the 'Optimal Portfolio'?

The TrueDiversification process uses an algorithm to calculate thousands of asset class combinations to identify the most favorable mix given the current market conditions. No way Harry Markowitz could have done that 60 years ago. That complex analysis reveals the combination of assets that have the best potential to provide the all-important diversification benefits – the Optimal Portfolio. In practice, we cap asset class weightings at a maximum of 40%. The end result is a concentrated portfolio of three or four of the most favorable asset classes.

Since you're pointing to current market conditions, how often are you making changes to the Portfolios?

There's no magic to this, but our analysis shows the best holding period is around one month. This period gives the momentum factor enough time to materialize while minimizing transaction costs and turnover. We rebalance to the Optimal Portfolio at the first of every month, with trades made as necessary. By utilizing low-cost, low transaction fee ETFs, by the way, we try to keep the expense drag on performance to a minimum.

So how does one Optimal Portfolio become five different Blueprint Portfolios?

Good question, and the answer comes from Markowitz's Efficient Frontier and Capital Allocation Line work. All investors should want to the Optimal Portfolio, just at varying percentages depending on their level of risk. Think of the Optimal Portfolio as the portfolio with the highest risk-adjusted return on the Efficient Frontier – the result of which is our Aggressive Blueprint portfolio.

For investors who seek more return than the Optimal Portfolio, we can increase the percentage invested by trading leveraged ETF's. The result is our Venture Blueprint portfolio, which targets twice the daily return of the Optimal Portfolio.

This approach creates a series of risk-based portfolios that can serve the full investor risk spectrum.

"We're confident the **Blueprint Portfolios** will get closer to achieving any investor's highest goal than any approach we've seen."

Thousands of combinations

Maximum of 40%

Monthly Rebalance

Levered Up or Down

Blueprint

/'bloo.print/

a design plan or other technical drawing that acts as a plan, model, or template.

Can you talk about performance?

We can. The actual Portfolios have only been live for a short while, but because of their defined approach, we can generate hypothetical results that go back more than 10 years. Without going into specifics, I can say the TrueDiversification process has delivered strong downside protection with a consistent return profile. During market rallies when the strategy is fully invested in equities, the beta can be greater than one.

In market corrections, when gold, Treasuries, or cash are used, the beta can be less than zero. Over time, the 3-year rolling returns are remarkably stable throughout the market's various conditions.

Do you think the Blueprint Portfolios get Fund Architects closer to its goal of delivering an improved client experience? Is it really the 'Holy-Grail' of portfolio construction?

We're under no illusion that TrueDiversification is a perfect system or it will work all the time because nothing in our business does. But we're confident, real confident, in fact, the Blueprint Portfolios will get closer to achieving any investor's highest goal – generating gains over periods short and long while mitigating drawdown risk at the same time – than any approach we've seen.

For more information, visit www.fundarchitects.com or call 866-539-4186
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