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Meeting Trust Distributions in a Volatile Market

Smart Investing Conference Call Series Handout

February 19, 2008

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Smart Investing Conference Call Series

Thank you for joining us as we discuss Meeting Trust Distributions in a Volatile Market on Tuesday, February 19, 2008 at 2:00pm (Central). Our goal at Comstock is to provide you with information that enables you to make investment decisions you can trust. This month our Chief Investment Officer, Steve Browne, CFA, will be looking at the current market trend and how it may impact trust investment decisions. Participants will have the opportunity to ask questions following his remarks.

Conference Call Presenters

Paul L. Comstock

Chairman, Paul Comstock Partners

Stephen C. Browne, CFA

Chief Investment Officer, Paul Comstock Partners

*To participate on this call, dial **(888) 632 5950** and reference **Smart Investing Conference Call**.

New Improved Website Just Launched! Visit the new **Smart Investing Conference Call Archive** at www.paulcomstockpartners.com under **Resources**. This call will be available on the website five days following the call.

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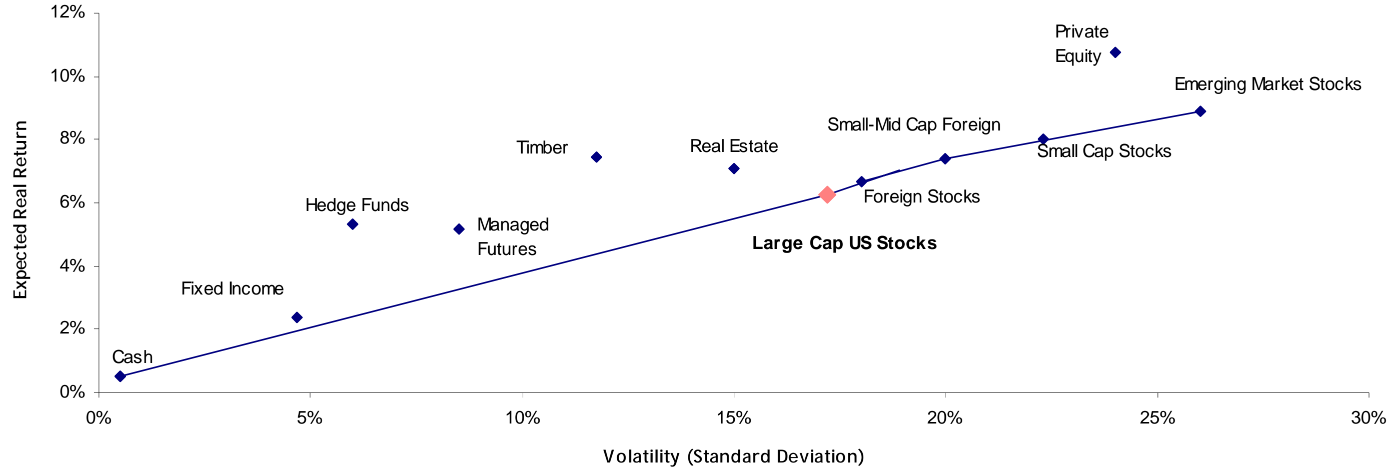
* Mark your calendar for next month's call: Monte Carlo Analysis: Not All Created Equal on Tuesday, March 25, 2008 at 2:00pm (Central).

What are "Fair" Rates of Return?



- Historical returns are likely unrepeatable
  - From 1871 to 2001 real EPS growth has been 1.25%[1]
  - From 1926 to 2004 a doubling in the P/E ratio accounted for 90 basis points of the S&P 500's 10.4% annualized return[2]
  - 25+ years of declining interest rates have distorted historical bond returns
- 6.25% expected real return from large cap US stocks =
  - 5% normalized earnings yield (earnings / price) + 1.25% real EPS growth
  - Represents what an owner could expect to earn if the companies in the S&P 500 were privately held

1. Jeremy Siegel: Stocks for the Long Run
2. Ibbotson Associates 2005 Yearbook

Risk Control is Essential for Successful Investing

- Portfolio losses are difficult to recover from when required distributions are being taken from the portfolio
- Risk cannot be expressed by statistics alone
- Traditional investment models often underestimate potential losses
- Avoid short-term investment fads
- Portfolios are structured to avoid any potential for catastrophic loss

Analyze Portfolio Exposure and Tolerance for Multiple Risk Factors:

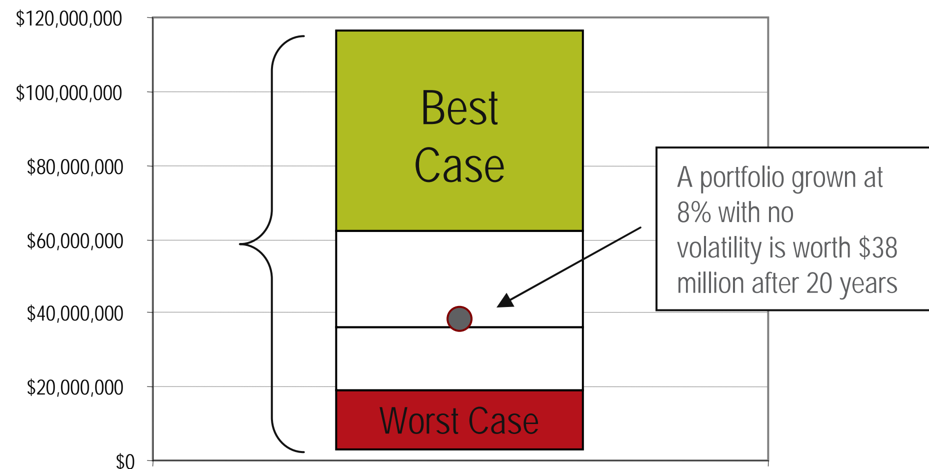
Macroeconomic factors
Valuation
Currency
Underperforming benchmarks (tracking error)
Inflation
Deflation

Credit risk
Liquidity
Statutory or Policy compliance
Fraud
Geopolitical events
Headline risk

Linear Return Projections are Unrealistic

Sample Analysis

Monte Carlo Simulation for a $20 million portfolio with an 8% expected return, 12% volatility and annual inflation adjusted withdrawals of $1 million



After 20 Years, 95% of outcomes were between $3 and $117 million

In nearly 5% of outcomes the portfolio was depleted

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More Risk ≠ More Return

- The importance of diversification is that it reduces risk without reducing the expected return of a portfolio
- Losses are difficult to make up:

	Portfolio A	Portfolio B
Year 1 Return	-20%	-10%
Year 2 Return	20%	10%
Total Return	-4%	-1%
Value with no distributions	$ 960,000	$ 990,000
Value with 5% distributions	$ 862,500	$ 892,500
Value after two $50,000 annual distributions	$ 850,000	$ 885,000

- Mathematically, it can be shown that a portfolio's median annualized expected return is reduced by its standard deviation
  - i.e. the return that you have a "coin-toss" chance of exceeding
  - The reduced median return is "made up" for in higher volatility portfolios by a low probability of huge gains

Annual Average Return	Standard Deviation	Median Compound Annual Return
10%	10%	9.5%
10%	15%	8.9%
10%	20%	8.0%
10%	25%	6.9%
10%	30%	5.5%

Comparable to concentrated stock positions

More Risk ≠ More Return

- This analysis took a $1,000,000 portfolio invested 65% in Large Cap US Stocks, 30% in Fixed Income and 5% Cash and then compared a more volatile portfolio where the standard deviation of the equity component was increased from the base assumption of 17% to 20%
  - The overall portfolio volatility increased from 11.6% to 13.4%
- 5% annual distributions were taken from the portfolio
- A Monte Carlo analysis showed the following return percentiles after 20 years:

Percentile	11.6% Volatility	13.4% Volatilty	Difference
95%	$393,201	$326,355	$66,846
75%	**$672,883**	**$601,634**	$71,249
50%	**$973,124**	**$910,512**	$62,612
25%	**$1,396,879**	**$1,399,058**	($2,178)
5%	$2,366,713	$2,540,961	($174,248)

- As one would expect, the tails are wider for the more volatile portfolio
- But the median is also lower for the more volatile portfolio
  - The portfolio would have a lower probability of meeting investment goals

How to Maintain Distributions in a Volatile Environment

- Maintain a high quality reserve of cash and fixed income securities adequate to cover several years of distribution requirements
- If risky assets decline in value their percentage weight of the portfolio naturally declines as well
  - Therefore distributions should come from cash and fixed income
  - This avoids selling assets at potentially distressed prices
- The caveat is that the quality of the fixed income and cash portfolio must be strong
  - High Credit Quality
  - Intermediate Duration
  - Credit risk is correlated to stocks
- Be skeptical of active fixed income management
  - Most approaches add higher yielding securities with credit risk to outperform benchmarks
    - This is beta, not alpha
- Hedge funds and other alternative investments are not substitutes for fixed income
  - Hedge funds generally perform poorly during periods of market turmoil
    - January 2008 was the worst month for hedge funds since April 2000
    - High quality bonds performed well during this whole downturn

For Long Term Portfolios, Inflation is the Real Risk

- When the Federal Reserve cuts rates to stimulate the economy it forces investors into a difficult choice, either:
  - Accept the certain loss of purchasing power over time by accepting bond yields that offer little or no premium to expected inflation
  - Accept the short-term volatility of riskier assets that have a high likelihood of delivering significant performance in excess of inflation
- Stagflation?
  - Stagflation is inflation + recession, last seen in the 1970s
  - *Inflation is always and everywhere a monetary phenomenon* – Milton Friedman
    - Government policies then are the significant risk factor – not commodity prices
    - Empirical data supports this, at least for high levels of inflation that would negatively impact investors
- Duration management is key for bond portfolios
  - Intermediate term durations (3-5 years) allow for reliability of income but the maturity dates are too short for inflation to seriously impact the purchasing power of the principal
- Stocks should pass through moderate levels of inflation
  - Consumers ultimately bear price increases, not corporations

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* Check out our new Smart Investing Conference Call Archives on our website under **Resources**!

* Save the Date – **Tuesday, March 25, 2008 – 2:00pm** (Central)
Monte Carlo Analysis: Not All Created Equal