Our Investment Philosophy

Investment management offers three potential sources of long-term return: gains from asset allocation, gains from market timing, and gains from security (or sector or manager) selection. Of these three, asset allocation—the distribution of investment capital across broad market segments and fundamental risk factors—is the most important and reliable source of long-term return. Market timing and security selection may add value from time to time, but are subject to greater uncertainty and higher costs. Hence, at Paladin Advisors, we focus our primary attention on achieving the optimal allocation of our clients' assets, reflecting their long-term investment goals and tolerance for market risk, as well as changing market conditions.

The foundational principles of our asset allocation process are diversification, value-based investing, and efficient execution. Diversification promotes greater stability and consistency of investment returns over time. Value-based investing improves the balance of reward vs. risk in our clients' portfolios over the long run. Efficient execution minimizes the drag on investment returns from management fees, trading costs and taxes.

Diversification of Investment Risk

Asset classes have been conceived and defined to represent fundamental economic and market risk factors (i.e., equity risk, credit risk, interest rate risk, liquidity risk, currency risk, etc.). These risks vary over time, with the dynamics of the business cycle and markets. For example, equity risk is lowest when the economy is in an upswing, whereas interest rate risk is subdued when inflation is falling and/or growth is slowing. The premium that investors receive for bearing these risks (i.e., the excess return over risk-free US Treasury bills) thus also varies over time.

To the extent that these underlying risk factors are distinct and, therefore, uncorrelated with one another, an asset allocation that is diversified across asset classes will exhibit less volatility than a portfolio that is relatively concentrated. A principal focus of our asset allocation strategy is to understand these risk factors and the relationships among them, so that we can achieve well-diversified and stable portfolios for our clients.

We draw upon a wide investment opportunity set, including stocks, bonds, real estate, and commodities. Within the equity portion of our clients' portfolios, we seek diversification across large and small capitalization stocks, value and growth-oriented stocks, and U.S. and international stocks. For the fixed income portion of the portfolio, we utilize US government bonds, municipal bond funds & ladders, mortgage-backed securities, international and emerging market bonds, and (on a tactical basis) corporate and high-yield bonds.

Additionally, we include in clients' portfolios a diversified array of *real assets*. These are investments that historically have held their value in the face of rising inflation, and include inflation-protected bonds, real estate, energy and other commodities. These investments not only serve as a hedge against inflation, they are a valuable source of portfolio diversification.

Globally-oriented investing is another key source of diversification. The U.S. market represents only 40% of global market capitalization, and there are large and varied opportunities overseas. Our academic training and professional experience give us an advantage in identifying global investment opportunities and managing the associated risks.

In contrast, we do not generally recommend that our clients invest in "alternative assets" such as private equity or hedge funds. These typically entail high fees, considerable tax/transaction costs, and illiquidity. Small investors find it difficult to gain access to the minority of funds that have demonstrated consistently superior performance. The large majority of private equity and hedge funds have delivered lower returns over the last 15 years, net of fees and capital gains taxes, than comparable investments in the public markets securities—even before adjusting for their (often higher) risk.

Value-Oriented Investing

Even well-diversified portfolios may experience large fluctuations, as the performance of, and relationships among asset classes are unstable. Correlations tend to rise when equity markets are falling, leaving investors without the benefit of diversification when they need it most. Correlated declines occur when many markets become simultaneously overvalued—as occurred in the period leading up to the 2008-09 global financial crisis. In such circumstances, diversification may not be sufficient to protect an investment portfolio from severe losses.

For these reasons, we manage our clients' asset allocations dynamically, within a disciplined, value-oriented framework. We establish ranges around portfolios' strategic allocations, within which we adjust target exposures. We utilize proprietary indicators to reduce clients' investments in market sectors that have become clearly overvalued, while increasing investments in those that are undervalued. This approach increases the likelihood that we are buying securities when prices are (relatively) low and selling when they are (relatively) high, thus improving portfolios' balance of reward vs. risk.

Although valuation is an important criterion guiding how our portfolios are invested, there are limits to which we will move our clients' allocations away from their long-term strategic targets. We believe that it is important to maintain well-diversified portfolios at all times, given the inherent uncertainty and volatility of markets. Moreover, since there are substantial tax and trading costs associated with allocation changes, we only adjust our clients' targets when the evidence of mis-valuation is clear and convincing.

As markets advance and decline, some assets in a portfolio perform better than others. Rebalancing involves selling (buying) assets that have appreciated (fallen) in value, in order to bring a portfolio's exposures back in line with targets. Intelligent rebalancing combines this value-oriented approach with a commitment to minimizing trading and tax costs. Deferring rebalancing decisions until a portfolio's exposures have moved materially (i.e. 10-20%) from target helps to separate the 'signal' from the 'noise' in market movements, ensuring that the potential gains from rebalancing are sufficient to offset the cost.

Many investors vacillate between greed and fear—buying as markets rise and selling when they fall. Value investing produces superior long-term returns, but requires discipline and consistency in the face of volatile markets. A value-oriented strategy may result in a client's having less exposure to a rapidly-rising market than he/she might wish, or more exposure to a poorly-performing sector that remains stubbornly out-of-favor with investors. For this reason, our investment approach is best-suited for clients with a long investment horizon.

Efficient Execution

Management fees, trading costs and taxes can take an enormous toll on long-term investment returns. Therefore, we seek the most cost-effective execution of our clients' portfolio strategies. Ample research has demonstrated that capital markets are efficient, meaning that individual security prices generally reflect all publicly-available information. Indeed, financial markets are so competitive that few investors—even professional ones—routinely profit at the expense of others. This well-established fact weakens the case for active security selection (the process of choosing individual stocks or bonds in order to achieve above-average returns).

Rather than pay high fees for actively-managed funds, we rely principally on cost-effective passive investment vehicles (index- and exchange-traded funds, or ETFs) that are designed to track broad market sectors. In less liquid asset classes (i.e., emerging market equity and debt, commodities) and in fixed-income sectors where there are multiple factor risks to be managed, we are more inclined to pay for active management. Modest allocations to actively-managed strategies are accommodated in core-satellite portfolio structures that remain cost-effective.

We are scrupulous about tax efficiency. Combined federal and state income tax rates now exceed 40% for many of our clients. Clients confront additional taxes on investment income, rising capital gains and dividend tax rates, as well as new limits on deduction of mortgage interest and charitable contributions. Given the heavy tax penalty on investment returns, we seek to limit the realization of taxable gains and income to what is strictly necessary. In addition to utilizing low-turnover, tax-efficient investment vehicles, we pay close attention to the distribution of investments across various taxable and tax-deferred accounts. Moreover, we rely on tax-loss harvesting techniques to neutralize capital gains whenever possible.

Our Investment Process

Existing Portfolio Audit

- Review of current investment strategy to determine suitability, efficiency, risk & return profile
- Provide written & oral assessment to client
- Determine what works & what doesn't work
- Discuss potential tax consequences of required & desired portfolio restructuring

Financial Plan

- Review income & spending plans pre- and post-retirement
- Determine capital needs in retirement
- Determine target rate of return, income requirements & cash cushion for portfolio

Risk Tolerance Assessment

- Client completes multiple quantitative assessment tools
- Qualitative discussion of client's history, experiences & risk perceptions
- Joint determination of client's *financial ability* & *willingness* to assume investment risk

Investment Policy Statement

- Documents client's investment objectives (target return, potential risk, required income & cash)
- Documents client risk profile and long-term capital market assumptions
- Establishes strategic & dynamic asset allocation strategy, portfolio rebalancing policy
- Sets parameters governing Paladin Advisors' discretion over client investment decisions

Strategic Asset Allocation

- Describes the long-term target allocation of portfolio assets, across major market segments
- Represents the 5-10 year "center of gravity" for our clients' portfolios
- Based principally on client's situation & objectives: target rate of return, risk tolerance, income needs, cash requirements, tax situation
- Grounded in long-term capital markets assumptions (asset class returns, volatility & correlation)
- Emphasizes broad diversification across geographies, market sectors

Dynamic asset allocation

- 1-3 year asset allocation targets, that fall within allowed range around strategic allocation
- Reflects changing market risks and opportunities, principally valuation risk & opportunity
- Sensitive to taxes & transaction costs, especially in initial portfolio transition

Instrument selection

- Focus on well-established, liquid & cost-effective passive investment vehicles
- Primarily passive strategies, although some active management in illiquid, complex sectors
- Goal to ensure broad and consistent exposure to the array of opportunities within asset class
- Diversified across asset class risk factors (equity, credit, interest rate, inflation & currency)

Asset Location

- Determine most tax-efficient distribution of assets across taxable & tax deferred accounts
- Locate high-return, income-oriented investments in retirement accounts
- Other considerations include: client's current & future tax situation, time until retirement, & charitable giving plans, as well as the share of taxable vs. tax deferred assets
- Diversification across and within accounts may be appropriate, depending on their purpose
- Distribute assets to allow for prudential reallocation, while minimizing tax consequences

Opportunistic rebalancing

- Goal: to filter the signal from the noise of market volatility
- Method: Establish rebalancing ranges around dynamic allocation targets
- First alert at 10% deviation from target; rebalancing required at 20% deviation
- Weekly review of portfolio positioning vis a vis targets
- Sensitive to taxes & transaction costs

Portfolio monitoring & performance analytics

- Monthly monitoring of portfolio performance: return, volatility, & income
- Consolidated quarterly reporting to clients of investment performance & interpretation
- Transparent reporting of advisor fee computations & deductions
- Periodic analysis of key portfolio components & investment vehicles
- Detailed portfolio income projections (quarterly or annual, as needed)
- Detailed reporting on sources of pre-vs. post-tax portfolio returns
- Comprehensive annual review of household net worth, investment objectives & performance