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THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Structured Asset Class Investing

KENNETH R. SMITH, CFP®, MS, Chief Executive Officer of Empirical Wealth Management, guides the firm's long-term strategy and leads its investment research team. He received a BS degree from the University of Arizona with a double major in Finance and Accounting. He holds a Master of Science degree in Financial Analysis and is a Certified Financial Planner® He is passionate about educating individuals on how to become smarter investors. He co-hosted an informative financial radio show with Empirical Wealth Management partner Jack Monteith titled, "Successful Investing" that was broadcast on AM stations in Washington, Oregon and Alaska. He volunteers as a teacher for Junior Achievement, a non-profit organization dedicated to educating and inspiring young people to succeed in a global economy. He has taught kids at the grade school level as well as the high school level and enjoys preparing them to address the personal financial planning issues they will face as adults. He is currently writing a book on personal finance intended to help individual investors make the most of their wealth building opportunities through intelligent investment and financial planning decisions.

SECTOR – GENERAL INVESTING

TWST: Please start with an overview of Empirical Wealth Management and perhaps you can tell us why it's called Empirical.

Mr. Smith: Empirical Wealth Management is a Northwest-based, independent wealth management firm with offices in Washington and Oregon. Our mission is to provide a superior wealth management experience to high net worth individuals. We define wealth management as the marriage of customized asset management solutions with comprehensive ongoing financial planning. We believe the best way to provide this service and accomplish our mission is to act as a fiduciary for our clients, placing their interests before ours. Einstein once said, "Try not to be a man of success, but rather be a man of value." We are committed to adding real value to our clients' lives.

The name Empirical is derived from our commitment to remain independent in our thinking and apply scientific rigor to our investment solutions. We think of it as evidenced-based investing. In developing portfolio policy, we look to the academic world for empirical evidence. If the empirical data does not support an approach, we will not use it in practical application. For example, we avoid market timing and stock picking because we believe the preponderance of evidence concludes that there is little consistency among winners and that the higher expenses associated with active management reduces investor returns below market rates.

With regard to our values, our objective is to bring the best available wealth management solutions to our clients. Because we act with undivided loyalty to our clients, our advice is untainted by conflicts of interest. This means we will not create proprietary investment products or receive remuneration from any investments we recommend. It is our view that we are compensated to help our clients make a lifetime of smart financial decisions.

TWST: What is your investment philosophy?

Mr. Smith: In short, Empirical's investment philosophy can best be described as structured asset class investing. As mentioned before, we do not market time or engage in conventional active investment strategies such as stock picking or sector rotation. The focus is on building a globally diversified portfolio of "core asset" classes, the objective being to maximize "success" as each client defines it. In contrast to traditional active managers who believe that markets are inefficient and therefore opportunity exists to profit by market failures or mispricing, we exploit what modern portfolio theory has taught us about the way markets work.

Further, we prioritize investment factors by what is relevant, controllable and important. While this may seem like an obvious way to approach investing, many investors, including professionals, focus on factors that possess the least of these qualities such as which individual stock, sector or country to own. These decisions are the least relevant, controllable or important determinants of returns. Investors should understand that they can greatly enhance their investment experience by minimizing non-market (unsystematic) risk through broad global diversification. The focus should be on getting and keeping the right asset allocation of stocks, bonds and other assets throughout their investment horizons.

Investors should also strive to manage controllable factors like investment expenses and unnecessary taxes. Research done by Eugene Fama and Ken French demonstrated that the best way to look at risk and return is with a three-factor model. The model states that within a diversified portfolio, most of the expected return and risk can be explained by the level of exposure to equity (relative to bonds) and within equity, the exposure to size (large cap relative to small cap) and style (growth companies relative to value companies). Higher equity exposure results in a higher expected return, higher value exposure and small exposure also results in higher expected returns. These are the factors we place most emphasis on when constructing portfolios for our clients.

The process for every new Empirical client begins with a thorough discovery process before any portfolio recommendations are made. During the discovery process it is important to include an assessment of the investor's risk tolerance (emotional reactions to risk) and risk capacity (the financial ability and need to take on risk) along with their view on how they would like their portfolio to behave relative to a standard market index, say the S&P 500 Index. Many investors and their advisers combine risk tolerance and risk capacity as if they were the same thing. They are not and they should be considered separately.

At Empirical we embrace international diversification and include other meaningful asset classes such as US and international REITs in our portfolios. We believe that passively managed mutual funds or ETFs are the best way to employ a structured asset class approach and build a globally diversified equity portfolio. We are not looking for sexy, we are looking for what works. These vehicles are extremely efficient and extremely tough to beat. We utilize mutual funds that take passive management a step farther by attempting to eliminate some of the few weaknesses inherent in traditional index funds. We employ Dimensional Fund Advisors (DFA) funds in many asset classes. You need to be a client of an adviser like Empirical to gain access to DFA funds. We believe for individual investors who cannot work with an adviser like Empirical, traditional index funds are the best bet.

TWST: Does that entail macro top-down research?

Mr. Smith: No, we are not basing our asset allocation decisions on macroeconomic analysis. Research has shown that economists are no more accurate than are stock pickers when it comes to predicting market trends in a meaningful way. A great book I would recommend to your readers is William Sherden's *The Fortune Sellers*. Instead, we are looking at research that shows us how to construct portfolios to survive difficult markets and get our clients to their stated objectives with the least amount of catastrophic risk.

Instead of conducting fruitless analysis of the market, we focus on the important factors of investing. Investors should construct a portfolio that is grounded in sound investment policy and remain disciplined through every type of market cycle. As I mentioned before, there are rewarded risks an investor can take to enhance their long-term portfolio return through the asset class weighting decisions that they make. There are fundamental economic reasons why investors should expect rewards for taking risks this way. Stocks should return more than bonds because of greater risk, small companies more than large companies and so on. Investors need to abandon the search for the Holy Grail of riskless returns and begin to embrace the notion that returns should only come with additional exposure to rewarded (systematic) risks.

Now, how far an investor tilts their portfolio to various systematic equity risks (small companies or values companies) and away from a total market index is a matter of their time frame, preferences and concerns about benchmark risks. For the client who says, "I would like to target a higher than market rate of return, I am willing to take on additional risk to do so and I have a long period of time to wait for that return to show up," we'll start making tilts. A tilt toward smaller, a tilt toward value and we'll do it in the US, in the international and emerging markets. The level at which we tilt will depend on the client that we are working with.

TWST: How has Empirical Wealth Management been doing over the last 12 months? It's been a very difficult environment for both stocks and bonds. What is your outlook going forward?

Highlights

Kenneth R. Smith says his firm's approach is focusing on strategies that are substantiated by empirical evidence. He constructs portfolios for clients that are based on confirmed asset allocation theory and empirical evidence of market sector correlation and returns. He searches for the best investment tools available at the best price and then augments these tools with comprehensive financial planning and careful customer care. Empirical data supports Modern Portfolio Theory, which states that assets should be selected on the basis of how they interact with one another, rather than how they perform in isolation. In this way, investors can hope to achieve the highest possible return for the amount of risk taken. They can benefit by combining the different asset classes in a structured portfolio and he typically incorporates 15-21 distinct asset class when building client portfolios.

Mr. Smith: Over the last 12 months our portfolios have declined in accordance with global markets. Our focus has been on tax management through active tax loss harvesting in our taxable client accounts. We have spent time communicating with and reviewing financial plans for our clients. I'm very proud of the retention rate we have experienced during this market decline. Our efforts at educating and reviewing asset allocation decisions with our clients have paid off.

As far as my outlook going forward, I don't spend a lot of time trying to figure out when the recession will end, when earnings growth rates will return to a specific number and so on. The reason I don't engage in that behavior is because there are people a lot smarter than I am trying to figure that out who can't do it. I believe that the market is efficient when it comes to information in that we all have access to market information at the same time. This does not mean we don't look back with the benefit of hindsight and determine that prices got irrationally optimistic or pessimistic at times. What it means is that I have no informational advantage over others to determine when these irrationalities will reverse. Therefore I refuse to play the game and I expect that at times I will receive returns beyond fundamental justification and at other times I will receive returns below fundamental justification.

The tendency for economic growth and market prices to move in this way is often referred to as mean reversion. I do believe that history shows us that when everything looks gloomy and market prices compress, future expected returns are higher because of the perceived risk. Robert Shiller from Yale looked at stock returns, following p/e ratios that were above and below long-term averages, and found this tendency to be true.

The long-term average growth rate is primarily determined by future earnings expectations and dividends. However, in the short term, the day-to-day market volatility is driven by the speculative component of investing. That shows itself in the short-term expansion and compression of p/e ratios rather than long-term earnings estimates.

My view is that with the declines that we've seen, the expected return for the next 10 years will be higher than it was before this drop. Because of this, the first thing we want to do with our clients is stay consistent and disciplined about rebalancing, getting them back to the target allocations. Being patient and disciplined has always been the best way to ride these types of markets out in the past, and I believe this time is no different. History shows us you don't have to miss the market downturns to get the good long-term average.

In summary, my advice to our clients and to other investors is to stay the course and make asset allocation changes primarily as a result of personal circumstance changes, not because of what market prices have done recently or what an analyst thinks they will do in the near future.

TWST: Have you been finding opportunities in this market for investors for their asset allocation?

Mr. Smith: Again, we don't market time; we have made changes on the fixed income side of our portfolios over the last couple of years. We increased our allocation toward inflation-protected bonds, TIPS, from a 10% to a 30% allocation because there was very little near-term inflation expected and the prices on the TIPS had become very attractive. At the time we increased TIPS, the market was projecting virtually no or negative inflation for the next 10-year period. We thought this was a reasonable adjustment to make. We also have stayed focused on the shorter end of the maturity curve and higher quality issues of bonds. On the equity side of things, we don't make a lot of changes there based on current economic or market conditions other than the opportunity of the tax loss harvesting. We've done a lot of that over the last two years as a result of the market declining and our investment approach being passive. Again, because we believe markets are unpredictable, we focus on the controllable factors. We know with certainty our clients will pay less tax in the future because of the tax losses we have banked.

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TWST: Tell us about the equity portfolio and about the areas where you do see growth.

Mr. Smith: I touched on this a little before**.** We believe that research has shown that dividing up the market between the large companies, small companies, growth companies, value companies, and exposing yourself to those asset classes or those categories, sub-classes in the US market, the international market and the emerging markets in a way that maximizes the risk return relationships is the key way to build and manage a portfolio regardless of what the current economic conditions are. We don't do a lot of sector rotation other than the fact that the market itself determines that by deciding what company is a value or growth company as a result of valuation changes. We start with a market neutral portfolio and then begin to layer in tilts. We also examine the US to international weighting decisions by looking at how the world markets are divided up once per year. Once we know that, we will make a decision on whether to adjust our foreign exposure. There is a case to be slightly home biased, in our opinion, due to expenses and taxes.

If we make deviations from the market weightings, there has to be some economically justifiable reason. If there isn't, then we are just placing unsubstantiated bets for our clients. Instead we focus on how do our allocations look across the US, the developed international and emerging markets, because to us, these

are all "core" asset classes. We will always have exposure to them. We have US and foreign REITs in the portfolio. Right now for the last few years, we've had about 5% exposure and we've been thinking and re-examining the research and asking ourselves if we should be at a 10% exposure there. As an aside, prices on REITs declined substantially but have seen a major increase from market lows in March of this year.

We don't make decisions based on our belief about the direction of sectors in the short term but just as an ongoing part of our research, we do examine the valuations of the asset classes we own; that's a part of the process.

TWST: When you are building a typical client portfolio, is it mostly about the asset allocation of different asset classes?

Mr. Smith: That's right.

We don't rebalance simply because a certain amount of time has passed. It may wind up being that it's once a year in certain cases, but in other cases, maybe it's once a quarter that some rebalancing is done. We implement a look window and before trading we ask, "Did we breach any of the thresholds that would justify a trade after considering tax implications and any transaction costs?"

TWST: Is it your aim then that you eliminate a lot of the risk through diversification of these different asset classes?

Mr. Smith: That's right. We believe there is rewarded risk and there is unrewarded risk. The risk that the client takes with our portfolio is the systematic risk we spoke of earlier. It's the risk of owning the entire world market so when the market goes down, that is the risk that all investors are dealing with. We are in a global recession, so everyone is dealing with these issues. We try to eliminate the unsystematic or unrewarded risk — the risk of overweighting to some category where there is no long-term economic payoff.

"One of the benefits of diversifying to the extent we do is that when markets decline, you can expect recovery at some point. For investors who have taken on the rewarded or systematic risk, they have already paid the premium of being an equity investor and that premium has shown itself in this last market decline. Now they need to stick around to capture the reward."

We think one of the benefits of diversifying to the extent we do is that when markets decline, you can expect recovery at some point. For investors who have taken on the rewarded or systematic risk, they have already paid the premium of being an equity investor and that premium has shown itself in this last market decline. Now they need to stick around to capture the reward. But it's different for someone who put all their money in Washington Mutual or Enron because there is no amount of time they can wait and expect recovery.

There are no free lunches in the market; we don't think there is a silver bullet to avoiding market declines. I laugh when I hear things like global diversification failed in this recent market downturn. How has it failed? Whoever said diversifying guarantees you won't see decline in your portfolio? That is ridiculous, and what is the alternative to diversification? Would not diversifying be a better strategy? The best thing we can do is educate clients about the different types of risks they are taking and why they should tolerate rewarded risk and eliminate unrewarded risks they shouldn't be taking.

TWST: Approximately how many asset classes are in a typical portfolio?

Mr. Smith: On the growth side of the portfolio we have 15 different asset classes, on the fixed income side of the portfolio we are utilizing four different asset classes. We divide equities up between large and small and then value versus growth, though we don't target growth because growth has a lower expected return and oftentimes blended indices become growth tilted. Therefore, we typically start with a blended index like the S&P 500, for example, and then tilt our large exposure by adding a value fund. In small cap, for example, we have a small and micro-cap blend and then we will tilt with a small value. That's kind of the lens that we look at the market through, and when you take that and then do it in international, emerging, in addition to REITs and a commodities index, you arrive at 15 different asset classes in the portfolio.

TWST: How often do you rebalance or review clients' portfolios and decide to make shifts in asset classes?

Mr. Smith: We utilize a layered approach to rebalancing. We use a program called Tamarac that enables us to set parameters around each asset class. We start with the fixed income to equities tolerance and then continue with tolerance levels at each sub asset class — large versus small within US and so on — and then within those classes, how much should we have in large blend versus the value components. We run client accounts on a weekly basis to see if anything has moved beyond the thresholds. When we do tax management, we are constantly looking for opportunities. We set minimum trade sizes for each client specifically and we engage our clients regarding the minimum tax loss trade for their accounts.

TWST: What do you think differentiates your approach to wealth management compared with other peer firms?

Mr. Smith: I think we do that on multiple levels. We do it with our investment philosophy, we do it with our business values in the way we approach our role with clients, and each Empirical adviser does it individually with their commitment to

excellence. Associates in our firm are chosen because they are highly dedicated to doing what's right for clients. Every decision we make starts with the question "does this improve our client's situation?" We don't accept soft dollars; we won't create or use funds or products in which we get some form of compensation. We want to be completely independent. We have dedicated ourselves to finding out what is the best way to build a portfolio and it's not about anyone's particular set of knowledge in our office, predicting markets or identifying those things but rather staying dedicated to being objective and impartial. It's not some proprietary mindset that we've created and now we have to stick with it even if it's not the best thing to do.

The industry has been rife with conflict in the past and guys like John Bogle among a few others have tried to expose and change it. We are unique in the level of detail we go to with each individual client, we want to connect with them and understand not only their tangible goals but their financial values. By doing so we aim to bring solutions to the forefront that give them more meaningful lives at a high level. We think this is a unique goal in the financial services industry.

TWST: What challenges ahead do you see for your investors that they should be wary of now?

Mr. Smith: Currently, it's my view that the biggest challenge are the emotional and psychological biases that all investors have. I am writing about this now in a client letter; we have a propensity as humans to take current trends and then project them indefinitely into the future and make decisions based on that. What I mean by that is that we've had two really difficult markets within the decade. I fear that investors will give up on markets at the wrong time just as they have in the past. Consider 1979, when an article titled "The Death of Equities" came out in *BusinessWeek*. The article talked about how smart investors were moving out of stocks and into hard assets. The subsequent 10, 20 and 30 years were brutal for those who followed that advice. I fear that investors will be susceptible to new "structured products" claiming to offer the higher return without the risk.

What you find is that there are a lot more efficient ways to build portfolios than a lot of the structured products I've seen. In general I think the biggest risk for investors is in projecting the current trend of negative returns indefinitely into the future and thus pulling their money out of the market as individual investors have done in the past. Look at the mutual fund cash inflows and outflows at market tops and bottoms; you will see the average investor pays a price. I'm especially sensitive to the retired group of investors because they do not have a lot of time to recover from large mistakes. They don't want to lose what they've worked so hard to gain.

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TWST: Is there anything you would like to add?

Mr. Smith: I believe that there is a trend toward passive management and I hope it continues. Too many people are still missing out on the facts and are making poor financial decisions. This bothers me and I hope we see a better financial system as a result of the recent financial crisis.

I hope the trend toward individuals utilizing independent fee-only advisers continues as well. Investing and financial planning are not easy for individuals to perform on their own; they need qualified, conflict free help. Historically speaking, some of my heroes like John Bogle and Burton Malkiel, who wrote the book *A Random Walk Down Wall Street*, weren't huge proponents of financial advisers. Their story was, you buy an index fund and basically you leave it alone. It seems they both have changed their position about that and now recognize the importance of sound advice. Knowledge alone is not enough because our emotions tend to get in the way of logic. There is so much that we have learned about individual behavior in finance that tells us that we are not programmed as individuals to be great investors. There is a lot of value in having somebody work with you and review what you are doing when you are making financial decisions and doing that with somebody who does not have an axe to grind.

TWST: Thank you. (PS)

Note: Opinions and recommendations are as of 7/17/09.

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