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## Inside An Advisor's Investment Mix

by Howard W. Wolosky

"We first determine the risk profile and the time horizon. Then, we recommend a portfolio of investments that reflect the client's specific needs. We adhere to the principles of modern portfolio theory, which holds that a properly balanced, diverse portfolio will perform better over time than any particular asset class. We recommend a diverse portfolio balanced among several asset classes.

Periodic rebalancing is important to insure that the portfolio maintains its relative allocation over time," is how William Meyer III, partner with Strothman & Company in Louisville, Ky., describes his firm's basic investment approach. As most advisors follow this approach, differences in advisors can be seen in the investment types they employ.

### Some Overall Mixes

"For our clients that have smaller amounts of total investable assets, we use primarily mutual funds along with some individual stocks via separately managed accounts with specialized investment managers. For larger clients, the range of the type of investments can be quite large depending on the circumstances and preferences of the client. The type of investments can include hedge funds, private equity funds, and specialized partnerships such as oil and gas, timber, and unique specialties," explains David Fisher, chief investment officer and partner in F&D Advisors, an affiliate wealth management group of Atlanta-based Frazier & Deeter. In particular, with regard to mutual funds, F&D Advisors typically uses specialized mutual funds that when combined together are diversified by market cap, sector, and geography, according to Fisher.

"Our firm's philosophy is to use a broadly diversified approach. In addition to maintaining cash reserves based upon the client's near-term liquidity needs, we want to maintain positions in bonds, U.S. stocks, foreign stocks, and tangibles such as real estate investment trusts, natural resource funds, and commodity exposure. The mix is determined by focusing on the client's

long-term financial objectives and risk tolerance with a Monte Carlo overlay using probability forecasting," says Mark Smith, president of M. J. Smith and Associates, which is affiliated with Raymond James Financial Services, in Englewood, Colo.

On the fixed income side, M. J. Smith and Associates likes a diversity of Triple AAA rated bonds as a core position, complemented with some high yield and convertible bonds. On the domestic U.S. stock side, it usually creates a blend of large cap growth and value investments along with small- and mid-cap growth and value positions. Internationally, diversification is obtained with a core position in a mature economy large cap complemented with small cap and emerging market holdings.

Carina Diamond, managing director of SS&G Wealth Management, in Akron, Ohio, reports that in general the typical mix of investments for their clients is as follows: 20 to 30 percent fixed (which includes U.S. bond funds, foreign bond funds, real estate, mutual funds, and real estate preferred stock mutual funds), 20 to 30 percent international, 40 to 60 percent U.S. (small, medium, and large stock mutual funds), and 5 to 10 percent private equity REITs. It generally uses no-load funds and A Shares at NAV in fee-based accounts rather than individual stocks.

Equities, mutual funds, exchange traded funds, bonds, REITs, oil and gas partnerships, and on some occasions high-quality annuities, are the investments used by **Donald Hoffman, president of The Prosperity Consulting Group, who is also a partner with Hertzbach & Company, both in Owings Mills, Md.** He uses all asset classes in mutual funds to provide a proper asset allocation model custom designed to each client's needs. A large portion of accounts are managed accounts, therefore the clients are

purchasing mutual funds without paying any commissions or sales charges.



Donald Hoffman,  
a partner at Hertzbach  
& Company, P.A.,  
is also president of  
The Prosperity  
Consulting Group, LLC.

Generally, Mark Lindstrom, tax and financial planning partner at Hansen Jergenson Nergaard & Co. in Minneapolis, employs a typical mix of investments that includes mostly mutual funds (no-load "A" class), individual fixed income securities used when possible (i.e., enough funds to properly diversify with individual securities), and large cap mutual funds replaced with individual stocks, if the client desires, and if the funds allocated to the large cap holdings are large enough. He reports individual stocks are basically never used for small cap and international holdings, although some large-cap foreign stocks have been found in portfolios.

### Picking Stocks

Meyer utilizes separately managed accounts consisting of individual stocks chosen by an investment manager for most clients. For the smaller net-worth clients, it is typically no-load institutionally managed funds.

Hoffman employs individual stock holdings in two situations, when using high-end private money managers, and in a limited way, when a client has a passion for a particular company.

F&D Advisors doesn't buy individual stock holdings for a client portfolio, although its outside money managers will obviously manage separately managed accounts on some clients' behalf. "Generally, our only assistance with individual stocks is in transitioning a client with an existing portfolio to our platform, a 'manager-of-managers' approach," reports Fisher.

Smith reports that for clients with individual stock holdings, his firm assists in analyzing these holdings using outside stock analysts.

"On occasion, when our clients would like individual stocks in their portfolio, we recommend private money management firms who will manage these portfolios," he says.

### **Corporate and Tax-Exempt Bonds Concentration**

Because a significant portion of its client base is the individual investor, Fisher indicates that F&D Advisors utilizes tax-exempt bonds extensively. "Our preferable method to gain access to municipals is by hiring an outside manager who concentrates on the inefficiencies in the asset class. Additionally, we use bond mutual funds for clients that can't meet the outside manager minimums," he explains. For the clients who have a taxable mandate, F&D Advisors uses government and corporate bonds to the extent that their outside money managers see value. As with tax-exempt bonds, outside money managers are also used.

Lindstrom places taxable fixed income securities in qualified accounts. With low-tax bracket investors, he employs them to maximize after-tax yields. Corporate securities with quality bond ratings are used by him to supplement or increase gross yields. "We rely almost exclusively on Honkamp Krueger Financial Services, Inc. (HKFS), to make specific fixed income holdings decisions," says Lindstrom. Hoffman indicates corporate bonds are used by his firm in an individual overall asset allocation.

Meyer goes to bonds or bond funds when the client needs fixed income as part of the investment strategy. "Tax-exempt bonds are used when the rate of return exceeds the after-tax return of a taxable bond, which depends on each client's specific tax situation."

Actual bonds aren't extensively used by SS&G Wealth Management. "We generally keep exposure between 20 to 30 percent and use mutual funds as opposed to individual issues. We also utilize CDs and money market accounts as bond alternatives," Diamond explains.

Although Smith prefers bonds to mutual fund holdings because there is an established maturity date and "therefore, interest rate and price fluctuation can be largely ignored in the interim, and there are no management fees," he does opine that "to effectively ladder a bond portfolio, you must have a larger pool of assets of \$200,000 or \$300,000 allocation amounts, or more."

### **Move To Exchange Traded & Index Funds**

Exchange traded (ETF) and index funds are used by Hoffman to complement the actively managed funds in an asset allocation model. He also uses ETFs to maximize tax efficiency. Both help F&D Advisors gain access to asset classes with limited investment options, or as a more tax-efficient option in an asset class where the other vehicles are tax inefficient.

They are also used, according to Fisher, when there is a determination "the asset class has lim-

ited value for active management and owning the 'market' is a better option."

Index ETFs (S&P 500 growth and S&P 500 value) are now only in a couple of large qualified accounts, reports Lindstrom, where the ETFs will be held for a long period of time. "Currently, all equity mutual funds used in the HKFS model equity portfolios are actively traded, although passive large cap funds have been used for some of the large growth and large value holdings in the past and might be again in the future depending on HKFS's determination of the value of active management in the prevailing economic environment," he adds.

### **Hedge Funds and Other Alternatives**

F&D Advisors actively utilizes alternative investments in client portfolios, primarily to reduce risk and dampen portfolio volatility. "We believe most of the asset classes deemed 'alternative' have historically been more inefficient and can be exploited to deliver strong risk-adjusted returns," explains Fisher. Its largest allocations in alternative investments are in hedge fund of funds, energy, natural resources, and private equity.

Meyer doesn't recommend hedge funds, although he points out that some of his firm's tax clients invest in them. In his experience, clients who use hedge funds generally don't understand how they are performing until they ultimately divest, and the tax reporting can be complicated. Hoffman only utilizes a very small portion of hedge funds depending on the particular individual asset allocation model to create balance.

Rather than hedge funds, private equity REITs are utilized for SS&G Wealth Management clients who need a current income stream and for those who want an inflation hedge and price stability. Similarly, Lindstrom occasionally complements standard model equity portfolios with private REITs, private oil & gas programs, and REIT mutual funds.

### **Omnipresent Closely Held Business Interests**

Meyer points to a problem experienced by many advisors. "Our CPA practice consists primarily of closely held businesses. The owners of many constantly reinvest company profits in the business in order to grow. This is certainly a noble goal. However, one of our key recommendations is to build a diverse investment portfolio outside the company. A tax-efficient way for many to do this is to set up properly structured retirement plans. While all employees of the business must be included, there are ways to maximize the contributions made on behalf of the owners."

Lindstrom also makes sure that closely held business owners are using the tax-qualified retirement plan type best suited for their situation. He

adds, "Cyclical business market swings, industry type, and geographic business exposure are occasionally taken into account in determining how aggressive or conservative to be with other funds under management."

F&D Advisors mostly works on the planning side to incorporate closely held business holdings into an overall plan. This includes specialty planning techniques to coordinate these holdings with their overall cash flow, estate tax planning, and charitable giving goals.

Since a closely held business ownership interest may represent the single largest asset they own, Smith reports that his firm helps analyze exit strategies from the business.

"We get involved in buy/sell decisions as well as other succession planning topics. These transactions, including sale projections, are closely integrated into their retirement cash flow forecast and are linked to the portfolio design," Smith explains.

### **Gaining International Exposure**

The managed accounts that Meyer's firm recommends often contain an international component. If not, Meyer may select international mutual funds to obtain this exposure.

"We believe that most long-term investors need to have a portion of their portfolio invested in overseas investments," he explains.

SS&G Wealth Management obtains the exposure through a variety of international mutual funds. Similarly, The Prosperity Consulting Group relies on high-quality mutual funds. F&D Advisors uses mutual funds, separate accounts, and, at times, international ETFs.

### **Future Investment Considerations**

Fisher sees rapid changes taking place in the investment world.

"The advent of new technology and the globalization of the markets have combined to provide intense competition for capital and a surge in new investment offerings," he explains.

Fisher predicts one area that will be extremely active over the next few years is the structured product market, and observes, "Many managers are also attempting to operate in less regulated areas of the market which is behind the large rise in hedge fund and other alternative investment products."

*Hoffman only  
utilizes a very small  
portion of hedge funds  
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