4th Quarter and 2014 Year End Update

2013 ends with most of our core models meeting the risk and return characteristics of their no-fee respective diversified index benchmarks. With the exception of the Conservative Model, we met our goal of 'riding along' with the market flow relative to the corresponding benchmark, at a time when tactically trading the market was not in favor. Any decision to get out of equities, especially domestic, would be followed up by getting in at a higher level. These trades would necessitate increasing the risk by concentrating the positions or using leverage just to get even with the buy and hold index. We place a premium on being able to define when it is better to not trade, because we hold risk at the customer tolerance and don't make any trade needed to beat a benchmark.

As the year ends, I want to look back at some of the decisions we made through the year, and try to provide a framework for you to get a better understanding of the way we allocate portfolios. We define our performance attribution in terms of strategic, tactical, and manager selection effects on the returns and that is a good way to look back at the past year.

The strategic allocation is the longer term allocation used in creating the diversified portfolio, and it is of particular interest in our year end results. The underperformance of the Conservative model relative to the Morningstar benchmark is rooted in the strategic allocation of the portfolio. The equity to fixed income ratio is the main indicator people understand, but there are many other decisions that go into the creation of a diversified model. There are various mathematic techniques to creating these long term strategic allocations and they tend to have similar outputs based on some generally accepted methods. While our Conservative portfolio and the corresponding Morningstar Index had similar equity to fixed income ratios, our strategic allocation contained a greater allocation to Inflation Protected securities.

The first quarter was very bad for Inflation Protected securities XXxXxXx. And our strategic overweight in the class relative to the Morningstar benchmark caused us to underperform during the quarter. Our tactical indicator then picked up on the weakness and we underweight that and other fixed income classes. I want people to understand this because 2013 was a time where we had a strategic underperformance, but followed it up with a tactical outperformance. The weakness for remainder of the year in the fixed income classes showed that we made a good tactical decision to underweight as we outperformed the strategic model. Choosing to stay put until the following year when recalculating long term assumptions, as most buy and hold managers do, creates a structural problem for investment managers that is more about operations than investment need. Unfortunately, the outperformance was not enough to make up the gap created in the first quarter.

This is not an attempt to avoid blame, as we take full responsibility for the strategic allocation percentages. We also believe that the way we create our strategic models is not only very effective for diversifying portfolios, but efficient in the ability to utilize tactical decisions. It is the process as a whole that we believe leads to successful investing. The ability to combine the strengths of the diversified portfolio with the ability to make timely changes, as we did in the Inflation Protected class, through the incorporation of a tactical overlay offer investors the best of both styles.

We start the new year at full equity exposure in our core models and a continued underweight of all bond classes except for high yield. Duration is shortened in all models, and Inflation Protected securities are underweight. Our long term strategic model adjustments will be coming shortly as we recalculate based on the year end, and as always, each class is being monitored from a tactical standpoint

We thank you for you continued confidence in our investment philosophy and look forward to 2014

Jason Rolence CFA
Senior Portfolio Manager
Premise Capital