Premise Capital
STAY ON THE CURVE™

Premise Capital 3rd Quarter Investment Commentary

	Q3 2017		YTD 2017	
	Return	**Std Dev**	**Return**	**Std Dev**
BBgBarc US Agg Bond TR USD	0.85	3.06	3.14	3.53
BBgBarc US Treasury US TIPS TR USD	0.86	4.01	1.72	4.29
BBgBarc US Treasury 20+ Yr TR USD	0.58	11.15	6.26	11.57
BBgBarcrclays US Corporate High Yield TR U	1.98	1.85	7.00	2.38
S&P 500 TR USD	4.48	8.51	14.24	8.45
S&P MidCap 400 TR	3.22	11.44	9.40	12.35
S&P SmallCap 600 TR USD	5.96	13.91	8.92	15.71
MSCI EAFE NR USD	5.40	7.80	19.96	9.59
S&P Developed Small NR USD	5.98	7.89	16.91	9.18
MSCI EM NR USD	7.89	11.06	27.78	11.04
FTSE NAREIT All Equity REITs TR	1.11	12.62	6.04	12.05

Premise Investors,

2017 3rd Quarter

The 3rd quarter demonstrates another rare time frame where Premise's tactical models remain at weights that reflect long term strategic models at all risk tolerances. Current weightings are consistent with the team's goal of achieving a maximum equity diversified model in uptrends, while maintaining the tools that allow for a possible exit. Each risk tolerance model is currently positioned at max equity to fixed income levels. Since it was a good time to be long all equity classes, I decided to write a little about the creation of long term strategic models.

"In the long run, we are all dead."

That was the title of a college economics book that looked at the difference between long and short term economic policies. Acknowledging that some forecasts are reliably accurate over the long term, it begs the question: "what should the investor do now in the short term?" How does an investor position for today's environment where short term data is more random and erratic?

This battle is fought in all manner of business situations, but is especially prevalent in investing. There is a constant push and pull from what fundamentally should happen and what actually happens. Being right, but only after a substantial move in the opposite direction, is the same as being wrong, as the pain it takes to hold the position may force an unnecessary early exit. There are smart people on both sides of every issue, guaranteeing someone will call the next great disaster and be the media darling, despite them calling for the disaster all the way up the eight-year bull market.

This balance haunts asset allocation strategy decisions by advisors and investment firms in establishing their capital market assumptions--the key inputs of Modern Portfolio Theory(MPT)--as they greatly affect the class weights in the efficient frontier. Experience shows that estimates tend to be more accurate the longer the time period used. The relationship is reversed when looking at short term numbers as they tend to be more random and erratic.

So, while creating asset allocation models that are more "accurate", due to their longer-term nature, investors must give up some of the short-term realities of the current market environment. Long term asset allocations tend to ignore looming disasters and assume that in 30 years markets will revert to the mean. [This is especially problematic when these portfolio creators exhibit survivorship bias and just exclude classes that have had bad performance in the long term, or don't include classes that may have been major players 30 years ago but have long since been marginalized.]

Premise Capital 3rd Quarter Continued

In one sense, investors can see how these long-term asset allocation models are exactly what the financial industry needed. They look over longer time periods and have the greatest possibility of using "accurate" assumptions to create the allocation models. This results in a long-term portfolio that is reasonable to use in long term financial planning.

But remember, "In the long run, we are all dead!"

While that portfolio is most likely to pan out over the long run, what happens when an investor has a time frame that is vastly different than the horizon used in the creation of the allocation? Clearly, a 70-year-old doesn't have a 40-year time horizon, yet that may be part of the assumptions used in the creation of the efficient frontier. The result given by the current paradigm simply fills the basket with fixed income. In the past, that wasn't such a bad default position as the bond market was in a 30-year bull market and fixed income provided enough return to support investors through retirement. Those days are long gone; fixed income can barely keep up with inflation, let alone provide for the needs of the investor.

This leaves the asset allocators and advisors in the same old quandary. The asset allocations are created using traditional long-term inputs that are most likely to be "accurate", but in the short run can cause pain associated with portfolio drawdowns in a declining market, or conversely, under-performing in an up market because too little risk was taken. These are the risk-tolerance-based allocations prevalent in today's financial industry as advisors try to match a client's individual risk tolerance to frontiers created with long term assumptions.

The industry has tried to address this issue, realizing that the investing public is tired of the same old story of a "diversified long-term allocation" being the best solution in all market environments. After witnessing two nearly 50% drawdowns in a ten-year period, some investors never had time to realize the fruits of a "long term" solution. A retiree in 2000 saw few gains over a decade, all the while drawing from the account and depleting principal.

The Premise team took a different approach. While acknowledging the benefits of the mean variance optimization (MPT) process used in creating the long-term allocations, we decided to focus on the quality of the inputs to make the process more nimble and adaptive to the current environment. We recognized that, at one extreme, 30 years might be too long a time frame for some individuals, while at the other extreme, market timing over days, weeks, or months was too erratic and random. We needed a way to adapt, but not fall prey to every market wiggle in the opposite direction.

Today, over 5 years after launching our Frontier Based Tactical models, we believe we have proof of concept. With subtle changes in the weights of the classes, the models have been able to keep track with the average asset allocation at various risk tolerances, despite moving to more conservative allocations on two occasions when risk was elevated.

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Premise Capital 3rd Quarter Continued

Since the Premise launch in June 2012, there were numerous times the markets looked scary and fear was creeping in (Hurricane Sandy, fiscal cliff, government shutdown, US debt downgrade, Ebola, Greek debt crisis, flash crash, election uncertainty, etc.), having markets retrace 5-10% on each occasion. However, it turned out to be a bull market with most equity classes sitting near highs, which is usually a terrible time to be a tactical manager. But through this time, the Frontier Advantage Portfolios have performed well, especially considering our policy of controlling overall equity risk exposure and concentration risk*, unlike many tactical managers. There will always be times when certain investment styles outperform others. If a tactical style has the potential to protect assets in extreme down moves and can keep pace with a “buy and hold” strategy over a 5-year bull market period, then that style may be more useful than simply relying on the markets to meet expectations over the long term.

Remember, in the long run, we are all dead.

Jason Rolence
Partner

*Investing involves risk, and there is no guarantee of positive returns in any market environment.