Getting to the Core of Model Portfolios

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Model portfolios are being touted as the investment industry's newest and best solution. Investment managers submit their models to broker sponsors who then package these style and asset classes into various diversified programs, tailored to investors with varying risk appetites. Despite all the hoopla, these programs could stand improvement, and certainly will evolve. For example, one area that has gone unnoticed is "core", defined as the stuff in the middle between value and growth. Most model portfolio programs acknowledge a middle range in company size by employing large, middle and small capitalization managers. But none realize that there is a similar middle in styles: there is a core in between value and growth. Ignoring this core leads to poor diversification and the consequent exposure to poor performance. Mid-cap companies do not perform like large and small companies, so there are good reasons to treat them as a separate category. Similarly, "homogenized core" stocks, defined as the stuff in the middle as opposed to a blend of value and growth, perform differently than value and growth. Using the Surz style index definitions, core surprises about a third of the time on a quarterly basis by either outperforming or underperforming both value and growth; i.e. core does not fall in between these two styles about a third of the time. Accordingly, ignoring homogenized core is like throwing away the filling in an Oreo cookie – it's the sweet spot of diversification, around which value and growth revolve.

Here's what's happening in model portfolio programs. Value and growth models receive allocations that are roughly the market weights in these styles, plus the sponsor usually applies strategic bets above or below market weights to enhance performance. But these bets unknowingly underweight homogenized core all the time. Research conducted by Dr Frank Sortino of the Pension Research Institute and Sortino Investment Management indicates that allocations to skillful value and growth managers systematically underweight the middle of the market. This is understandable in light of the scrutiny that most managers are under to maintain style consistency. Managers are incented to sell companies that drift toward the middle, away from their declared style. The result is an unintended bet in model portfolios away from homogenized core. This is a diversification mistake.

This is an easy problem to fix. Broker sponsors can refer to the composition of homogenized core as another, albeit passive, model. There's a good chance that many of the stocks in this model core portfolio will appear among the holdings of the current value and growth managers, so the diversification fix is as much on the weights as it is on the membership. Our definition of homogenized core is the 20% in the middle – it's 20% of the market. It's a simple matter to merge the current models' holdings in core with a model core to constitute 20% of the U.S. equity holdings. Sometimes the simplest solutions are the most elegant. The constituents of the current large cap core are provided in the following table.

Homogenized Large Cap Core Model Portfolio for Q1, 2007

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<u>Size(\$B)</u>	Company Name
26.52	BARRICK GLD
22.54	AETNA INC
22.66	AFLAC INC
186.26	AM INTL GRP
18.33	ALCAN INC
25.68	APPLD MATLS
15.21	AIR PRDS&CH
72.74	AM EXPRESS
29.76	BANK OF NY
169.6	BERKSHIRE A
37.83	ANHEUSR-BSH
17.55	CLEAR CHANL
35.48	EMERSON EL
41.53	EXELON
33.36	FEDEX CORP
47.03	FREDDIE MAC
30.17	GEN DYNAMCS
16.03	GAP INC
18.26	HARLEY
146.34	INTL BUS MA
116.6	INTEL CORP
16.84	JOHNSN CNTL
17.38	PENNEY (JC)
191.74	JOHNSN&JHNS
19.91	KELLOGG CO
113	COCA-CL CO
16.31	KROGER CO
38.79	
47.35	
23.07	LOEWS CORP
54.82	
44.85	
16.88	
49.7	
24.96	NIKE INC-B
	Size(\$B) 26.52 22.54 22.66 186.26 186.26 18.33 25.68 15.21 72.74 29.76 169.6 37.83 17.55 35.48 41.53 33.36 47.03 30.17 16.03 18.26 146.34 116.6 16.84 17.38 191.74 19.91 113 16.31 38.79 47.35 23.07 54.82 44.85 16.88 49.7

PEP	102.96	PEPSICO INC
PFG	15.83	PRINCPL FNL
PG	203.66	PROCTR & GM
PRU	40.98	PRUDNTL FIN
PX	19.16	PRAXAIR INC
RTN	23.46	RAYTHEON CO
STT	22.42	STATE ST CP
SU	36.27	SUNCOR ENGY
TGT	49	TARGET CORP
TOC	26.62	THOMSON
TWX	87.17	TIME WARNER
TXN	41.76	TX INSTR
TYC	60.56	TYCO INTL
UPS	80.53	UTD PARCEL
VNO	17.26	VORNADO RLT
WMT	192.48	WAL-MART
XRX	16.04	XEROX CP