Understanding the "Total Portfolio" Approach

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The Total Portfolio approach is how Orcam views the allocation of assets through an understanding of the capital structure and the monetary system at its operational level. Through this understanding we are able to more prudently and pragmatically invest assets on behalf of clients.

The allocation of savings on a secondary market is not "investment"!

What is "Saving" & "Investment"?

In economics, investment is purchases not consumed, for use in future production. If you start a company and purchase office space you are not consuming. You are investing in your company with the hope that this investment will multiply future profits over time. Most funding of investment is done on primary markets. *(Let's back up a second here just to be clear. Primary markets are different from secondary markets. Primary markets are where investments are made. This includes the private equity market or the IPO market when a company raises capital by selling shares to the public. The secondary market is the market where* ***existing*** *securities are* ***exchanged****. This includes markets like the NY Stock Exchange where trillions of dollars of existing securities are simply exchanged between shareholders.)*

When a private equity firm invests in a company they are seeding capital. The IPO market is the same. The company is obtaining capital that it will then invest in the company with the hope of leveraging this capital into higher future profits. The company will usually forego a percentage of ownership in exchange for this investment in the firm. When a company goes public they are selling the firm to the public and raising funds in exchange.

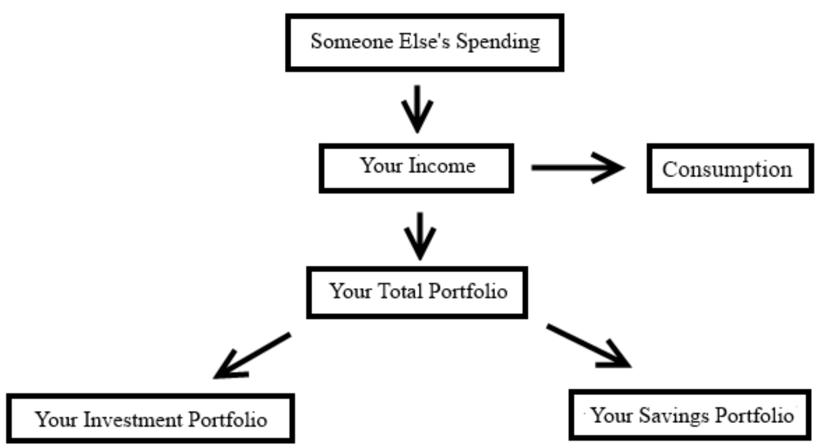
But an odd thing has occurred over the years. We now refer to security exchanges on the secondary market as "investment" even though this is not at all an "investment". When you buy securities on a secondary market like the NY Stock Exchange or through an E-Trade account you are engaging in a simple exchange of cash for securities. The company you purchase does not obtain funds or new investment capital. You are not actually investing!

So what are you really doing? You are actually allocating your savings. When you obtain income that goes unspent you are saving. If you were to put this in a "savings account" with your local bank they would purchase low risk securities like money market funds or government notes where you can earn interest. They are, in essence, buying securities on your behalf. They don't call this an "investment account" because that's not what it is. When you transfer funds into a brokerage account your funds will be swept into a default money market account. This is, for all intents and purposes, a near equivalent of the account that your bank might call a "savings account".

When you purchase shares of stock on a secondary market you are engaging in the exact same kind of purchase that occurs in the savings account with your local bank. You are buying shares of existing securities. The only difference is the level of risk involved in these securities.

The important thing to note here is that your investment portfolio is not really an "investment portfolio" at all despite the fact that we all refer to it as "investing". What it really is, is a saving portfolio. Your portfolio is a repository where your unspent income flows and is then allocated in the form of various securities that are designed to achieve a different return based on the performance of the issuing entities.

When we think of the flow of funds through our personal portfolio we should think of it as one "Total Portfolio" where your unspent income flows into a Savings Portfolio as well as an Investment Portfolio. Your Investment Portfolio should be thought of as

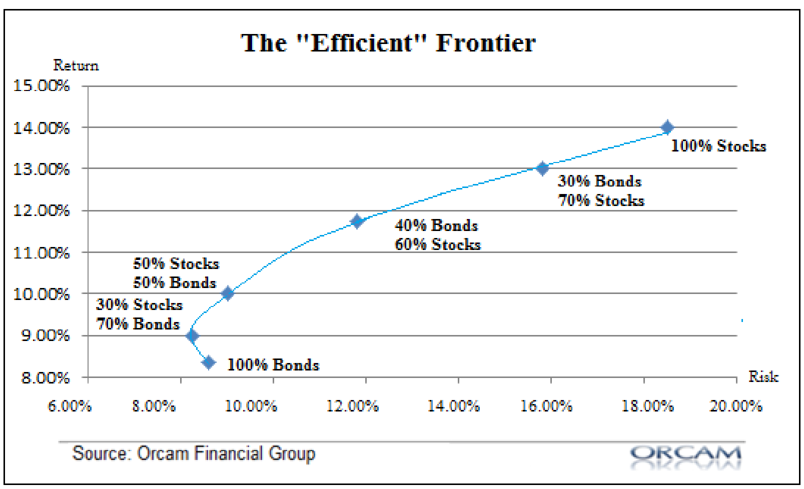


(Figure 1– Flow of Funds Through the Total Portfolio) the place where you make real investments in your future production. Maybe you are an entrepreneur or maybe you are investing in your area of expertise through education. These are funds you are willing to lose entirely. Your Savings Portfolio should be thought of differently. Your Savings Portfolio is where you need to allocate savings in order to plan for life's big events in the future. Because our financial lives are not one clean linear experience we have to account for the fact that this portfolio requires some degree of predictability and stability. It truly is our "life's savings" and it should be treated as such. These funds don't need to "beat the market" or be engaged in high risks necessarily.

At Orcam we believe your saving portfolio should achieve two primary goals:

1) It should protect against the potential for permanent loss.
2) It should reduce the risk of purchasing power loss.

Most of Wall Street and the media creates false perceptions around portfolio design by pitching the savings portfolio as an "investment" portfolio which results in excessive risk, excessive fees, excessive portfolio churn and sub-par performance. Of course, "saving" doesn't sound as sexy as "investing", but when you allocate your unspent income into securities on a secondary market that is indeed what you are doing. At Orcam, we don't believe saving is supposed to be sexy. Your unspent income is saved so you can predictably consume at a future date. If you buy into the "investment" myth you are likely taking on excessive risk and thereby increasing the likelihood that your savings won't be there when you most need it.



(Figure 2– The Efficient Frontier, Not So "Efficient"?)

The flaw in much of Wall Street's typical model for portfolio construction is that it revolves around ideas which generally lead to a stock centric portfolio. For instance, most money managers use Modern Portfolio Theory and the Efficient Frontier to match a client's risk parameters with those of a particular allocation as seen to the left. This approach uses standard deviation as risk, but this idea that risk is volatility is not at all how most clients perceive risk. Most clients perceive risk as the potential that they will not meet their financial goals. When placed in the context of the Savings Portfolio the two biggest risks are the risk of purchasing power loss and the risk of permanent loss.

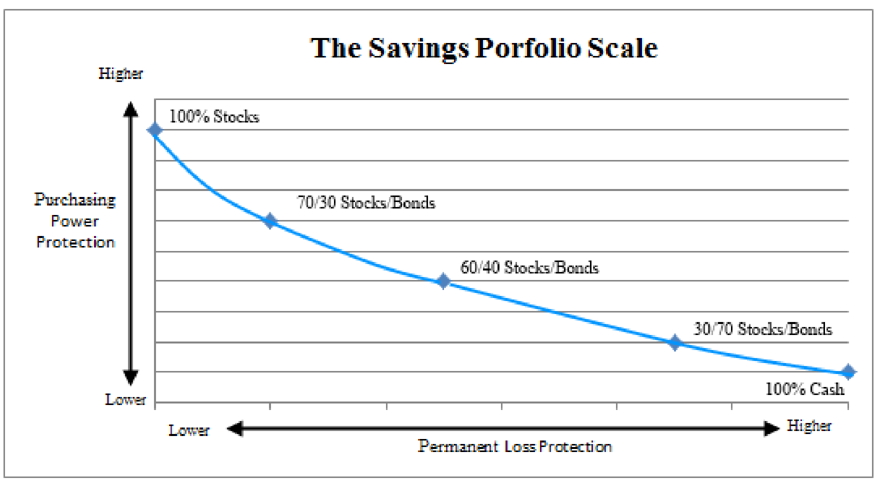
The flaw in relying on Modern Portfolio Theory and the Efficient Frontier is that you end up relying on a stock centric portfolio in most cases that results in high levels of risk. In other words, you are over-weighting the risk of purchasing power loss substantially over the risk of permanent loss. But our studies find that most clients are actually more concerned with the risk of permanent loss than the risk of purchasing power loss.

We are often told that stocks outperform bonds over the long-term and that this justifies a higher allocation towards stocks, however, this does not translate to the way most clients realistically manage their cash flow needs or perceive risks:

1. Portfolios suffer from the problem of time in a portfolio—what I call the "intertemporal conundrum". That is, a portfolio does not have one clean start and end date. There actually is no "long-term" within a portfolio because our financial lives are not one clean linear experience. They are a series of major expenses and financial "events" that require strict planning and stability as opposed to justifying excessive risks based on this inapplicable "long-term" view.
2. On a risk adjusted basis and a nominal basis stocks can and do underperform bonds for long periods of time.

The problem here is that the dominant portfolio frameworks used on Wall Street are misaligning the way clients perceive risk and the way assets are actually managed. In trying to "beat the market" by implementing a stock centric approach the asset manager is often overweighting the risk of purchasing power loss at the expense of the risk of permanent loss.

At Orcam we take a different approach. We use the Total Portfolio approach to help our clients understand how risk actually relates to their financial lives and we apply the Savings Portfolio Scale to help them perceive risk at their personal level. This approach helps us to manage assets in a way that ensures our portfolio management style is in-line with the way our clients are actually perceiving risk.



(Figure 3 – The Savings Portfolio Scale)

There Are No Holy Grails

We know there are no holy grails in the world of asset management. Strategies will come and go and investors will always chase the performance. But we believe that a sound understanding of the financial system and the monetary system substantially increases the odds that we can achieve our financial goals by constructing a portfolio that is based on a sound and practical perspective.

The Total Portfolio approach is by no means a holy grail, but it is grounded in a sound understanding of modern finance and the monetary system. We know that managing money through our lives is a dynamic process and portfolio management should be structured in such a way so as to establish a systematic and streamlined process based on empirical understandings. The Total Portfolio is an approach to portfolio management that substantially increases the probability that our clients will meet their financial goals.

For more information about Orcam Financial Group and our products and services please contact us at (858) 220-5383 or via email at info@orcamgroup.com

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