

# PARAMETRIC PERSPECTIVES

NEWSLETTER

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“To be blunt, if you think that you can do an adequate job of minimizing portfolio risk with 15 or 30 stocks, then you are imperiling your financial future and the future of those that depend on you.”

– William Bernstein, *The 15-Stock Diversification Myth*.

## ► Losses Are Back! (In a good way)

by Paul Bouchey, CFA — Director, Tax-Managed Research  
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I'll admit, it's a bit perverse to be excited about losses showing up in a portfolio, but it comes with the territory when you manage taxable equity portfolios. In 2007, we saw volatility come back to the markets and, although the S&P 500 index was up 5.5% for the year, the ups and downs of the last six months were enough to create excess stomach acid for even the most risk tolerant investor. An investor who ignored the markets and media (perhaps spending the last twelve months hiking in Peru) might wonder what all the fuss is about. Those of us who read the paper every day are worried about the credit crisis, the Fed, the fragile economy, \$100 oil, a housing market in decline, and the presidential elections...if you believe everything in the paper, you might think our entire capitalist system is on the brink of meltdown. Settle down; equities are a great place for the long-term investor and this type of market is perfect for loss harvesting. The accompanying table shows a few representative Tax-Managed Core accounts starting near the beginning of 2007.

Adding 2 to 3 percent in after-tax return is significant when the market is only giving you single digit returns. Loss harvesting is an excellent way to add value to an equity portfolio, especially when markets are down or volatile.

More important than loss harvesting, however, is holding a broadly diversified portfolio. This is how long-term investors will efficiently capture equity returns and ride out short-term volatility. It's a common myth that you can create a diversified portfolio with 10 to 30 stocks. Benjamin Graham put forth this idea in *The Intelligent Investor* and Burton Malkiel infected a new generation of investors with this meme in *A Random Walk Down Wall Street* (a great book otherwise):

“By the time the portfolio contains close to 20 equal-sized and well-diversified issues, the total risk (standard deviation of returns) of the portfolio is reduced by 70 percent. Further increase in the number of holdings does not produce any significant further risk reduction.”

Unfortunately, as William Bernstein points

out in his essay on the subject, “The 15-Stock Diversification Myth,” this conventional wisdom is also highly misleading. Risk is more than just standard deviation of return—it's also about compounded wealth at the investment horizon. If you construct random portfolios of equal-weighted 20-stock portfolios, you will find that their standard deviation of returns is quite similar to the S&P 500 Index; however, the dispersion of terminal wealth is significant.

Bernstein suggests that a significant number of these “diversified” portfolios underperform the market, because “a grossly disproportionate fraction of the total return came from a very few ‘superstocks’ like Dell Computer, which increased in value 550 times. If you didn't have one of these half-dozen or so of these in your portfolio, then you badly lagged the market.”

*continued on p. 4*

### NEWSLETTER HIGHLIGHTS

Losses Are Back	01
Example Covered Call Portfolio	02
Market Commentary	04

REPRESENTATIVE TMC ACCOUNTS - LOSS HARVESTING SINCE INCEPTION

BENCHMARK	INCEPTION DATE	PORTFOLIO MARKET VALUE (\$)	REALIZED SHORT-TERM LOSSES (\$)	REALIZED SHORT-TERM LOSSES (%)	AFTER-TAX BENEFIT (%)
S&P 500 Index	12/20/2006	3,396,968	233,457	6.9	2.4
Russell 1000 Index	12/21/2006	735,908	50,985	6.9	2.4
Russell 3000 Index	1/4/2007	2,572,460	209,835	8.2	2.9
FTSE RAFI 1000 Index	1/10/2007	1,696,638	139,415	8.2	2.9
MSCI EAFE Index (ADR)	12/19/2006	605,068	31,047	5.1	1.8

## ► Example Covered Call Portfolio

Parametric Risk Advisors, LLC, helps clients customize their return distributions through the use of disciplined option trading strategies, including covered call writing and the hedging of concentrated stock positions. DeltaShift<sup>SM</sup> is a systematic covered call writing and yield enhancement strategy that seeks to improve the total return of the client's concentrated stock position. Below is a case study designed to illustrate our investment process.

### CASE STUDY

Suppose you have 200,000 shares of ABC stock allocated to a long term, concentrated holding. You've already made charitable contributions and sold a significant portion to begin a meaningful diversification process. Rather than be passive with respect to those core shares, you've decided to proactively manage the concentrated position through a systematic, covered call writing program with the goals of enhanced total return and reduced volatility.

**Summer:** Initially two options are sold against 200,000 shares of stock, both with a strike price of \$30, one expiring in August and the other in September. Over the summer, the stock moves above \$30 and we closed the August position at a loss, selling 540 shares to cover (capital gains taxes may apply). We then sold a new option at \$32.50, expiring in October. The stock price went down dramatically over the next week and we quickly closed that position for a profit.

**Fall:** The stock stayed low through September and our initial September \$30 option expired on the 21st. A new option was sold at \$27.50 expiring in November. Later in October, we sold a second option at \$30 expiring in December.

**Winter:** We closed out the November option, breaking even, and the December option for a profit.

#### DELTASHIFT EXAMPLE TRANSACTIONS



TRANSACTION DATE	JUN	JUN	AUG	AUG	AUG	SEP	SEP	OCT	NOV	NOV	DEC	TOTAL
	18	19	15	20	28	21	24	25	15	22	21	
Stock Price	28.06	27.89	31.37	30.04	27.24	26.27	26.17	29.10	27.77	26.71	29.64	
Sell to Open	Aug \$30	Sep \$30		Oct \$32.50			Nov \$27.50	Dec \$30				
Net Rec'd	\$51,090	\$75,990		\$45,754			\$28,130	\$86,140				\$287,104
Buy to Close			Aug \$30		Oct \$32.50	Sep \$30			Nov \$27.50	Dec \$30		
Net Paid (-)			\$138,000		\$4,970	Expired			\$32,320	\$4,970		(\$180,260)
Sell Shares			-540									
Net Sale Proceeds			\$16,940									\$16,940

# PARAMETRIC PERSPECTIVES

## RESULTS

Over the course of six months, we generated an extra \$88,500 in cash, net of fees. If you consider that only 0.27% of the stock was sold, DeltaShift improved pre-tax returns by 1.3% while reducing volatility.

This example only shows a single path. What if the stock had risen 25% instead of just 5% over the course of this period? Based on this example, we would expect a DeltaShift portfolio to return 22%, with as much as 10 percent of the shares sold. On the other hand, if the stock fell by 25%, the premiums collected would cushion the fall and a DeltaShift portfolio would be expected to fall by only 20%, with few, if any, shares sold.

DELTASHIFT SHARE RETENTION	
Initial Shares	200,000
Shares Sold	-540
Remaining Shares	199,460

LONG ONLY REFERENCE PORTFOLIO					% OF INITIAL STOCK VALUE	
Initial Share Value	\$28.06	200,000	\$5,611,002			100.00%
Final Share Value	\$29.64	200,000	\$5,927,568			105.64%
<b>Long Only Total Return</b>			\$316,566			<b>5.64%</b>
<b>Volatility</b>						<b>25.51%</b>

DELTASHIFT NET CASH PERFORMANCE	
Net Premium Received	\$287,104
Net Premium Paid	(\$180,260)
Parametric Mgmt Fee	(\$18,343)
Net DeltaShift Cash Generated	\$88,500

DELTASHIFT TOTAL PERFORMANCE					% OF INITIAL STOCK VALUE	
Initial Share Value	\$28.06	200,000	\$5,611,002			100.00%
Ending DeltaShift Stock Value	\$29.64	199,460	\$5,911,563			105.36%
Net DeltaShift Profit to Client			\$88,500			1.58%
DeltaShift Final Portfolio Value			\$6,000,064			106.93%
<b>Net DeltaShift Total Return</b>			\$389,062			<b>6.93%</b>
<b>Volatility</b>						<b>20.22%</b>

## Disclosures

DeltaShift<sup>SM</sup> is a discretionary managed call writing program of Parametric Risk Advisors, LLC. This example is intended to describe generally how the program works, but it is not a complete description of DeltaShift or how Parametric Risk Advisors performs its investment management responsibilities.

The upside potential of covered call option positions is limited to the strike price plus the premium received. Unless the position is closed, the client relinquishes any upside potential above the call strike price. The downside protection afforded by covered call writing is limited to the amount of the premium received. If the stock held by the client declines significantly, the only protection will be the premium received. Retaining Parametric Risk Advisors to render investment management services and/or to manage a securities investment account may involve significant risks, including the risk that the account could suffer substantial diminution in value. Investors should have the financial ability and willingness to accept such risks.

The sale of stock will produce tax consequences for U.S. taxpayers. Each option transaction also produces a tax consequence. Prior to implementing the DeltaShift managed call writing program, you should discuss with your personal tax adviser how the options transactions and any sales of underlying stock will affect your tax situation. Neither Parametric Risk Advisors nor Parametric Portfolio Associates provide tax advice. Options are not suitable for all investors. Please ensure that you have read and understood the current options risk disclosure document before entering into any options transactions. The options risk disclosure document can be accessed at the following web address: <http://optionsclearing.com/publications/risks/download.jsp>.

This sample analysis is used for illustrative purposes and is not representative of all accounts. Your actual account will vary.

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## About Parametric

Parametric is an industry-leading provider of structured portfolio management, headquartered in Seattle, Washington. Parametric and its affiliate, Parametric Risk Advisors, offer a variety of structured portfolio solutions, including customized core equity portfolios (U.S., Non-U.S., global Tax-Managed Core™), options strategies (DeltaShift™), and overlay portfolio management (OverlayOne™).

## Total AUM (12/31/2007):

\$24.9 Billion

## Established:

1987

## Disclosures

This information should not be considered investment advice or a recommendation to buy or sell any particular security. The information in this material and specific securities mentioned are not representative of all securities purchased, sold or recommended for advisory clients. Actual portfolio holdings will vary for each client and there is no guarantee that a particular client's account will hold any, or all, of the securities identified. It should not be assumed that any of the securities or recommendations made in the future will be profitable or will equal the performance of the listed securities. It is not possible to invest directly in an Index. Past performance does not predict future results.

## ► Market Commentary

by Tom Seto — Director of Portfolio Management



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### Domestic

Credit risk became the chief concern of equity markets during the fourth quarter. The subprime-led devaluation of mortgage-backed debt significantly impacted the largest financial institutions. Ill effects spilled over to the broader market with the S&P 500 Index down 3.3% for the quarter. Still, the market finished 2007 with a moderate gain, with the S&P 500 Index up 5.5%. In the fourth quarter, Utilities were the best performing stocks, followed by Energy as oil prices set record highs. Financials were the worst performing, down 14.3%. Consumer discretionary stocks also continued to decline, down 10%. Small-cap stocks trailed large and mid-cap stocks for the third quarter in a row and finished the year in negative territory. Growth outperformed Value as investors moved away from the financial and cyclical stocks dominating the Value Index. The markets face much uncertainty in the coming year; a fragile economy, \$100 oil, a housing market in decline, and presidential elections all weigh heavily on the minds of investors. An ambiguous Federal Reserve is adding to investor nervousness. After slowly reducing interest rates in the fourth quarter, the Federal Reserve is under pressure to cut rates to avoid recession, but may be forced to maintain rates to contain inflation. Among this uncertainty, our broadly diversified, sector-neutral Tax Managed Core portfolios provide a great opportunity to capture the next market leaders, while doing so in a tax efficient manner.

### International

International markets continued to be volatile after a bumpy third quarter. While lofty returns carried over from mid-September through October, developed markets turned negative in November and December, ending the fourth quarter in negative territory. The MSCI EAFE Index was down 1.75% and emerging markets MSCI EM Index was up 3.64% for the quarter. Both finished with solid gains for the year, with MSCI EAFE Index up 11% and MSCI EM Index up 39%. In developed markets, fourth quarter results were driven by Japan, down 6%. Financials were the worst performing sector, down 5%, followed by Industrials and Materials. Telecom, Consumer Staples, and Utilities contributed positively as investors sought safety at the possibility of recession in 2008. In emerging markets, India, Russia, and Brazil posted gains but negative returns in China, Korea, and Taiwan, together composing more than 40% of the EM benchmark, nearly erased strength outside the Far East.

### Losses Are Back!

*continued from p. 1*

This is another type of risk that we usually don't talk about - outlier risk - the risk of not capturing exceptional returns, either by being out of the market at a crucial time or by not being invested broadly enough. There is a fundamental truth that investors and advisors sometimes forget: the capital markets were not designed with their interests in mind. The purpose of the market is to provide a ready source of capital to businesses, to promote the efficient allocation of resources, and to outsource risk to investors.

Investors live in a harsh environment: risk, inflation, taxes, transaction costs, and fees all conspire to erode hard-won returns. Being broadly diversified in a low cost and tax-efficient portfolio—and sticking with a long-term investment plan are strong defenses for surviving the ups and downs of the market.

In summary: volatility is back and it's a great time for loss harvesting, but the real reason to invest in a TMC portfolio is—as Tom Seto likes to say—for the “opportunity to capture the next market leaders.”