

PARAMETRIC PERSPECTIVES

NEWSLETTER

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“Look at market fluctuations as your friend rather than your enemy; profit from folly rather than participate in it.”

– Warren Buffet



Paul Bouchey, CFA, is the Director of Research at Parametric.
pbouchey@paraport.com

► You Need More Core:

Equity Portfolio Structure in a High Volatility, High Tax Environment

Most investors are underweight equities right now. Market returns have pushed equity allocations down relative to bonds and cash; and some have made a tactical move away from the stock market. With treasury bills yielding less than 2 percent, investors now face the decisions of how and when to move back into the market.

There is also the difficult task of assessing how investment managers have weathered the storm and deciding whether adjustments to the portfolio are needed. Greater than expected losses, disruptions at the firm, or other surprises (think Madoff) have caused investors to abandon certain strategies all together. In the background we must also consider the effects of an increase in government regulation and taxes.

How should investors structure their portfolio in a high volatility, high tax environment? We don't have all the answers, but we offer the following observations.

Observation 1) In the second quarter of 2002, during the last bear market,

Parametric published a commentary entitled “Strategy over Tactics” with the following introductory paragraphs (which still apply):

There is no question that a dramatic market decline creates strong pressure to react. Parametric has long advocated that one of the most important tenants of investing—particularly for taxable investors—is *strategy dominates tactics*. Portfolio structure should be designed to withstand inevitable tempests when emotions, competitive pressure, or the need for liquidity are at their height...

It is important, even fundamental, to remain continually aware that the industry and its constituents such as media, brokerage, and advisory, were built upon investors embracing tactics—not just a specific course of action, but a general tactical world view. Support for tactics from these camps should be observed with appropriate skepticism.

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Observation 2) Investments should be structured to take advantage of market fluctuations. Loss harvesting, disciplined rebalancing, and covered call writing are all examples of Parametric strategies that extract value from volatility.

Observation 3) Tax management is still relevant. Losses are plentiful now; but as we saw in 2003, losses carried forward can quickly be used up during a market rebound. Also, tax rates are likely to increase so that losses realized now may be more valuable in the future.

Observation 4) As you position for a recovery, consider adding more to a diversified, broad-market core portfolio. Concentrated portfolios face the real risk of missing out on a recovery. A well-structured core portfolio has less concentration risk and more transparency. Investors need both right now. Also, as volatility within the market increases, there is greater risk of underperformance—more volatility translates into more active risk from the same magnitude of over and under weights. We see this in our passive portfolios; we've had to tighten our industry and stock bounds to keep the same level of predicted tracking risk. In a core-satellite portfolio, with a passive core surrounded by active satellite managers, investors will need to shift assets to the core in order to hold a constant level of active risk in the overall portfolio.

How Should You Invest in the Face of Market Volatility? Use It.

Equity markets have taken a dramatic tumble in 2008. The increases in uncertainty, volatility and fear have led many investors to flee to Treasuries (as evidence of this flight to safety, note that the Vanguard Long-Term US Treasury Fund had a total return of 17.6% in Q4 2008).

The lack of demand for risky assets has caused a severe dislocation in prices in nearly every investment category. Stocks, bonds, real estate, commodities, even hedge funds—which are supposed to hedge out systemic risk—all suffered double-digit negative returns this year.

The sugar coating to this bitter pill is that asset prices are now attractive from a valuation perspective. If you can cope with the volatility, there are substantial expected return premiums to be earned. Price-to-earnings, price-to-book, and other valuation ratios are at 20-year lows.

Peter Bernstein, financial author, noted that in November the dividend yield on the S&P 500 (3.57%) exceeded the yield on the 10-year Treasury note (3.54%)—this is another way of gauging the relative attractiveness of equities and government bonds.

This does not guarantee positive returns going forward and we don't pretend to know where the bottom is or when markets will turn around. However, for those investors that are willing to take risk beyond holding Treasuries, it is helpful to note where current valuations and yields are.

Jack Bogle, the founder of Vanguard Group Inc., puts it more bluntly in a recent interview:¹

The total value of the U.S. stock market had dropped from about \$18 trillion dollars to about \$9.5 trillion. So there has been an \$8.5 trillion drop in the perceived value of corporate America. I think that's inconceivable. I don't think the value of corporate America has dropped by almost half. I mean, these are companies with capital—they make useful products and services, they're efficient, competitive, innovative. Does anybody really think the value of American business changes by a trillion dollars a day? Well, they may, but I don't.

It may be the market was overvalued at the beginning of the period. It may have been \$1 trillion or \$2 trillion overvalued when this thing started. But that still leaves \$7.5 trillion to account for.

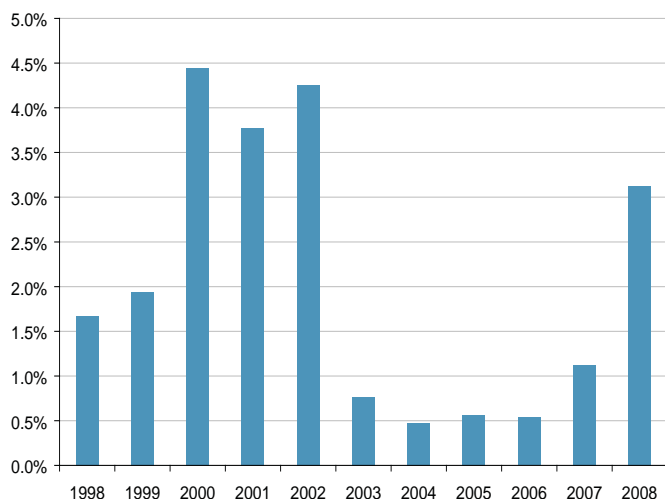
Core in a Separate Account, Not an ETF

ETFs are great: low cost, easy, diversified, tax efficient...but they can't generate tax losses that can be used to shelter gains from other parts of the portfolio and aren't as flexible and customizable as a separate account.

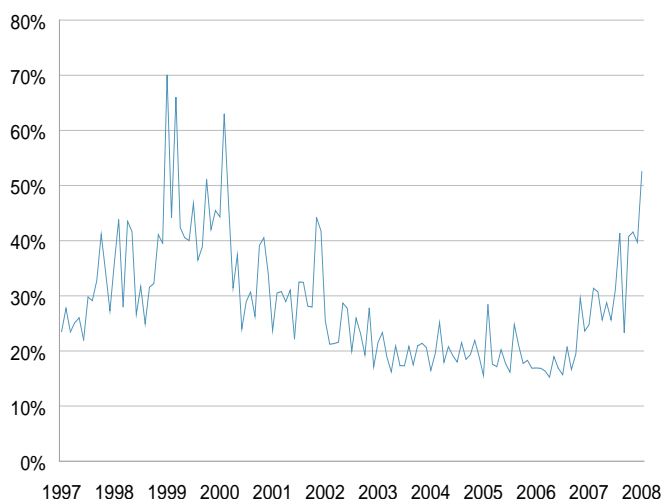
On the next page are two charts that demonstrate the relationship between volatility and the benefits of tax management. The first is a bar chart showing year-by-year tax alpha of our Tax-Managed Core accounts that are benchmarked against S&P 500 Index.

¹ From an interview with Mark Jewell, *Columbus Dispatch*, December 14th, 2008.

Tax Alpha for the TMC S&P 500 Composite
As of 11/30/08



Cross Sectional Volatility 10 Years (S&P 500)
As of 12/31/08



This is a measure of the value we create through active tax management. We calculate the after-tax returns of the portfolio and subtract the after-tax returns of the index. We also subtract any incidental differences in the pre-tax returns in order to isolate the effects of tax management. The after-tax return calculation penalizes us for any realized gain and credits us for any realized loss using the maximum federal tax rates.

It's clear that bear markets enhance tax alpha: 2000, 2001, 2002 and 2008 all had negative market returns and large tax alphas. However, there is another factor that drives tax alpha: cross-sectional volatility. Both 1998 and 2003 were +30% markets, but the former was driven by large cap technology stocks, while the latter was a broad-based recovery with all stocks up uniformly. The adjacent line chart shows the cross-sectional volatility of stocks—instead of a time series of re-

turns, we take the weighted standard deviation of stock returns within a given time period. This provides a measure of the variance of stock returns within the market—in essence, the width of the spread between the best and worst performing stocks. 1998 was a high cross-sectional volatility period (with greater opportunities for loss harvesting and higher tax alpha), while 2003 was lower volatility with less opportunity. There were ample opportunities for loss harvesting in 2008, even before the market crashed. The fourth quarter saw daily volatility at four times normal levels and with cross-sectional doubling in magnitude.

The average tax alpha over this ten year period was 2.00%. Under different market conditions, we expect to add between 1 and 3 percent of tax benefit on average over a ten year period.

Having lived through 2008, it's hard to be concerned with loss harvesting.

Losses are abundant in all parts of the portfolio and investors have built up more losses than they can use in 2008 and probably in 2009. However, our experience through the bear market of 2000 to 2002 is that investors generate realized gains faster than they expect during the recovery period and their appetite for losses comes back rapidly.

In summary:

- Strategy dominates tactics,
- Portfolios can be structured to take advantage of volatility,
- A broadly diversified portfolio is an ideal vehicle for capturing returns during a recovery,
- Tax management is still critical: tax rates are likely to increase and the appetite for tax losses will return quickly in a rebounding market,
- For investors using a core-satellite approach, a shift to core may be needed to hold active risk levels constant.

► Emerging Markets Brief

A Comparison to our Peers

by Matthew Kirk — Assistant Research Analyst

The following charts show how the Eaton Vance Structured Emerging Markets Composite compares with its peers. The Composite is comprised of Parametric-managed, Structured Emerging Markets accounts. As you can see the Composite has lower volatility and turnover while maintaining high diversification and substantial excess return after fees.

More information about our research on the last 10 years of emerging markets funds can be found in our pending white paper: "A 10-year Summary of Active Investment in Emerging Markets" by Sam Pittman, Matthew Kirk and Brian Dillon.

To request a copy please contact Matthew Kirk (mkirk@paraport.com).

Definitions

Volatility is a statistical measure of the dispersion of returns for a given fund or market index. Volatility is calculated as the annualized standard deviation.

10 Year Return after fees is the compounded annualized total return after fees.

Turnover is the value of securities bought divided by net asset value or securities sold divided by net asset value—whichever is less.



1151 Fairview Avenue N.
Seattle, WA 98109
T 206 694 5500
F 206 694 5581
www.ParametricPortfolio.com

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™), emerging markets (Structured Emerging Markets™), and overlay portfolio management (OverlayOne™).

Total AUM (12/31/2008):

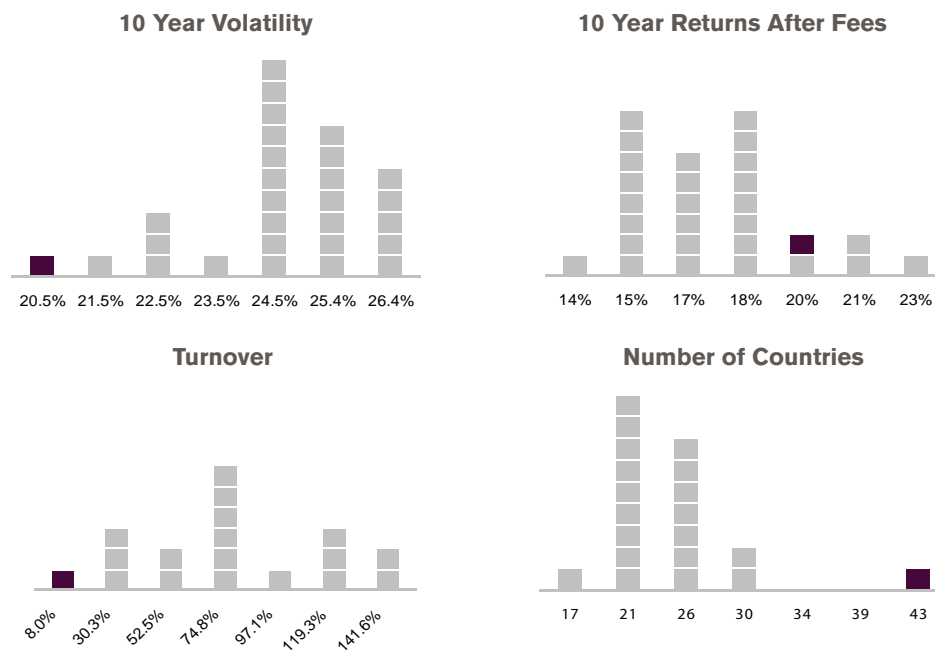
\$21.1 Billion*

*This figure represents the combined AUM of Parametric and its affiliate Parametric Risk Advisors.

Established:

1987

Sources: Parametric and eVestment Alliance. July 1st, 1998 through June 30th, 2008.



■ EV Structured Emerging Markets Composite, 10-Year Period
■ Peers in Emerging Markets, funds with a 10-year track record, data from eVestment Alliance

Disclosures

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