

FORWARD THINKING

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Forward Tactical Growth

Building Portfolio Potential Through Active Asset Allocation

Why It May Be Time to Rethink Portfolio Construction

The market decline of 2008 did more than erase \$2 trillion in asset value and wipe out years of progress investors had made toward their long-term goals. It also caused many to question the way asset allocation and portfolio construction have been approached over the last 30 years. Conventional wisdom was challenged as:

- ▲ Traditional, “conservative” stock and bond investments proved to be more volatile than investors ever expected.
- ▲ With a few exceptions (e.g., government bonds), asset classes with a historically low correlation fell in lockstep, leaving few havens. In essence, almost nothing worked.
- ▲ Equity investors experienced a “lost decade,” getting nowhere — in fact, losing ground — between January 2000 and December 2009. Despite surging ahead in 2009, the S&P 500 index closed out the decade more than 23% lower than it started.

Many investors now find themselves worried about market risks and unclear which way to turn. Should they be in the markets and risk another downturn? Or should they pull back, even at the cost of missing out on a market rebound? Faced with this uncertainty, investors might step back to ask a more fundamental question: ***How is my portfolio constructed?***

A traditional approach to asset allocation is formulaic and passive. Investors often have anchored their portfolios in “core” investments generally considered to be conservative. This generally means allocating to a mix of asset classes and investment vehicles guided by some formula (e.g., 60% stocks/40% bonds) relating to the investor’s age, investment objectives and risk tolerance. This is typically done by employing a set of managers who manage to specific benchmarks and are fully invested at all times. Once their asset allocation is set, investors typically revisit it only at preset intervals or in response to some major market upheaval.

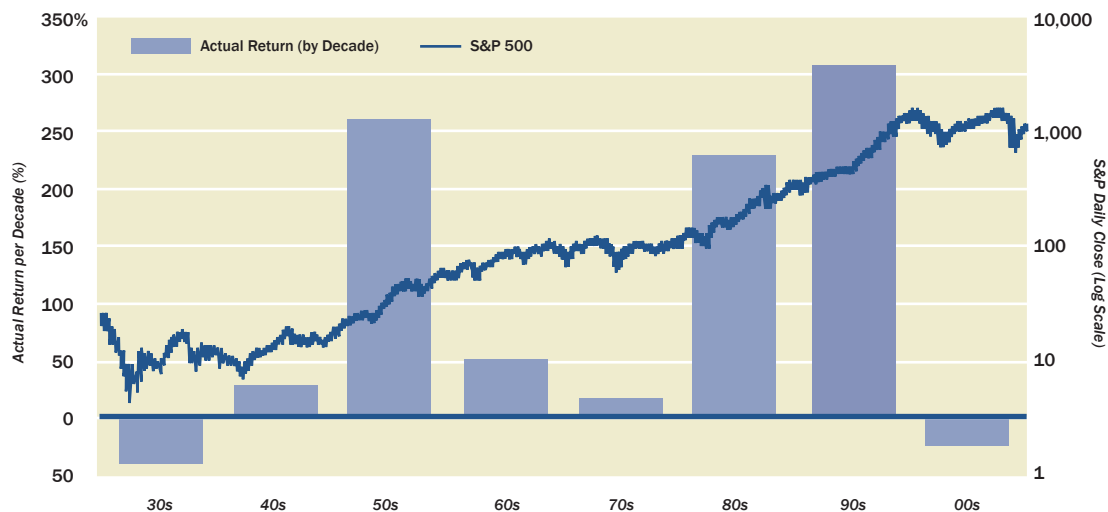
Unlike the traditional “set-it-and-forget-it” approach, active asset allocation continually manages market exposure.

Studies show that investment returns derive more from asset allocation decisions than from any other single factor, including security selection. Yet recent experience shows how quickly asset value can be erased by market moves. Rather than following the traditional “set-it-and-forget-it” approach, investors now have good reason to seek asset allocation methods better suited to the times. This has led Forward Management to introduce **Forward Tactical Growth**, an equity-oriented strategy based on a unique “active asset allocation” concept.

What Has Changed?

New views of “normal.” Seen in the context of three decades of generally rising markets, the current climate appears to be an anomaly. But when taking a broader view of market history, we can see other extended periods of flat or lackluster returns [Figure 1]. In reality, the current climate may be more “normal” than the preceding bull market runup.

Figure 1 S&P 500 Performance, 1930-2009¹



Source: Standard & Poor's, Forward Management, LLC

Lowered return expectations. The S&P's 23% loss from 2000 to 2009 stands in sharp contrast to the strong gains during the bull markets of the 1980s and 1990s, when the Index rose 234% and 308%, respectively. Even the relatively dismal 1970s, plagued by the oil crisis and stagflation, produced better returns than investors earned over the last decade. In fact, one needs to go all the way back to the Great Depression of the 1930s to find a ten-year period that delivered similarly poor performance.

While it is true that the S&P 500 returned an average 10.5% in the last half of the twentieth century, the average annual return over the past 80 years has been closer to 7%. It is also clear that returns can vary dramatically depending on when you enter and exit the market. This means that investors expecting 10% or even higher returns must now recalibrate for an era in which single-digit returns may be the norm.

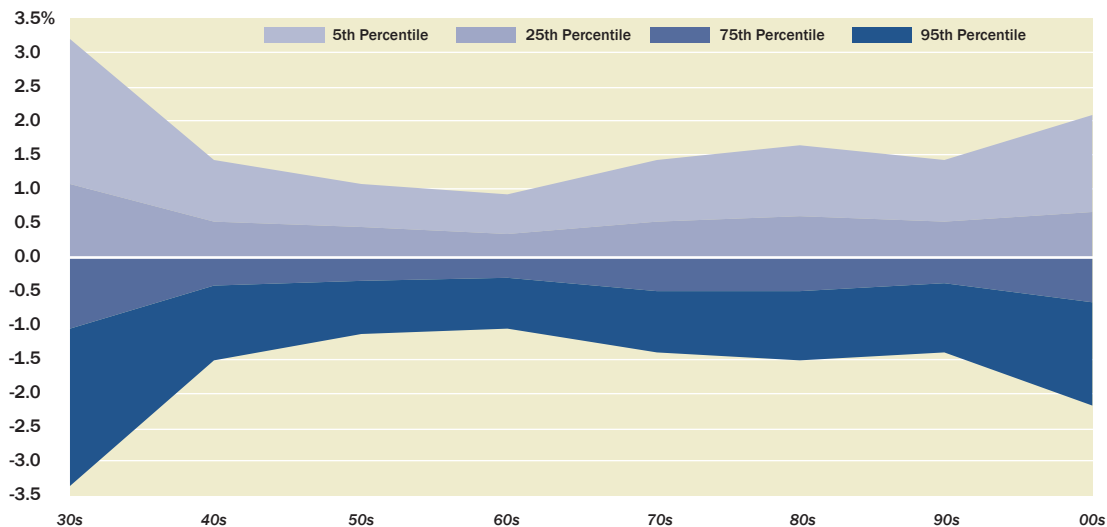
¹All S&P 500 performance analysis utilizes index price returns rather than total returns

This has dramatic implications for the long-term plans of investors, many of whom already find themselves drastically underfunded for their retirement or other financial goals.

A shift in objectives. Many investors have become more concerned with avoiding asset losses than with outperforming market benchmarks. One reason is based on pure mathematics: investors sustaining a portfolio loss must achieve an even higher percentage gain to get back to their starting value. If, for example, a portfolio drops by 25%, a 33% gain will be required to recover the loss. Thus, many investors are shifting their goals away from relative return and toward an absolute return orientation for at least some portion of their investment portfolios.

Higher volatility. Daily S&P 500 prices fluctuated more from 2000 to 2009 than in any decade since the 1930s [Figure 2]. The higher volatility is underscored by the fact that the past ten years produced 66 of the 100 biggest daily percentage price changes over the past five decades.

Figure 2 S&P 500 Daily Price Volatility, by Decade



Source: Standard & Poor's, Forward Management, LLC

Rethinking Risk Management

In the traditional approach, which measures performance relative to market benchmarks, investors have focused mainly on two kinds of risks: underperforming the markets, and volatility of returns. Traditional risk management thus defines a conservative portfolio as one that is:

- ▲ Fully invested in stocks and/or bonds, with a modest allocation to cash.
- ▲ Well diversified among multiple managers and asset classes to help dampen the effects of volatility.
- ▲ Periodically rebalanced to adapt to a changing market outlook.

However, this approach to risk management could be seen as inadequate in an era when broad, sudden market downturns no longer seem unlikely and many investors are more concerned with avoiding losses than with outperforming benchmarks. It's worth noting that for those seeking positive absolute returns, volatility can be beneficial on the upside and damaging on the downside. From this perspective, the traditional portfolio strategy of being fully invested in a diverse mix of long-only vehicles may no longer qualify as risk averse.

The Trouble with Traditional Thinking

Ever since Modern Portfolio Theory swept the investment world back in the '70s, it has shaped many of the industry's assumptions and practices. The resulting world view has become so entrenched that it has rarely even been questioned. But now, new realities are challenging formerly sacrosanct ideas:

Style Purity — Why should underperforming a benchmark be a greater sin than losing money?

Cash is Trash — Geared to ever-rising markets, this idea may not apply in an era of rapid market changes. A dictum not suited to downturns.

Certain Asset Classes Assumed to Appreciate — Many saw real estate, for example, as a reliable cushion against stock market risk.

Bottom-up Portfolio Construction — A mixed bag of strategies may not provide reduced volatility unless each one is grounded in an unifying world view.

Inflexible, Formulaic Asset Allocation — Standard templates are no substitute for thinking through each investment's role under varying market scenarios.

Core = Safe — The belief that traditional core equity and fixed-income investments are a more prudent approach has been undercut by recent experience.

What Works Now?

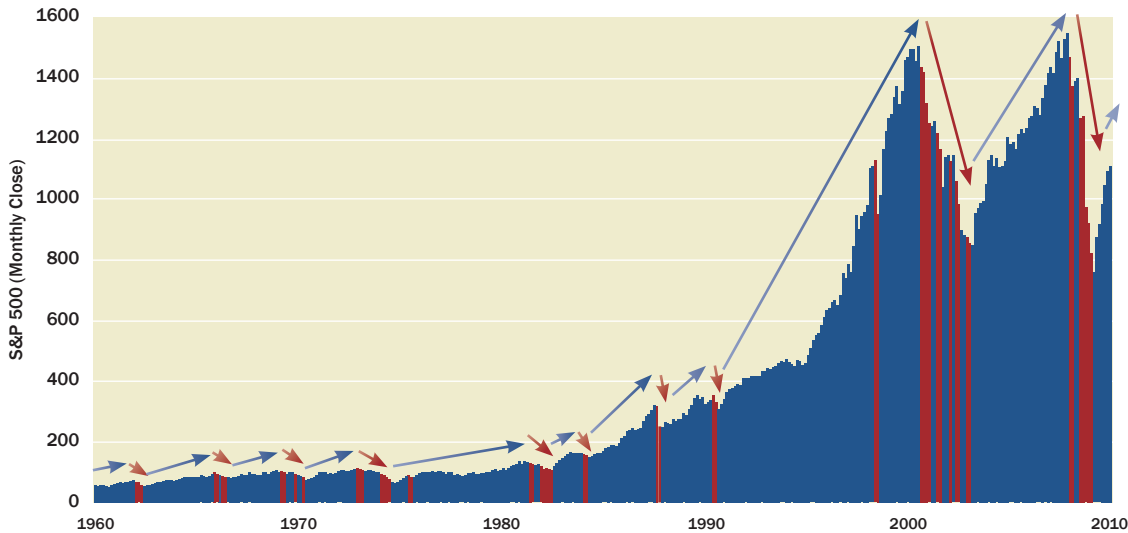
Today's market climate challenges investors to build portfolios that are positioned to benefit from market growth while withstanding market downturns — even capitalizing on them if possible. In these uncertain times, the more prudent strategy is likely to be the one that manages market exposure, rather than one that is invested 100% long at all times regardless of how managers view market trends.

Looking back at market history, one sees periods when investors would obviously want to have been exposed to the market had they wished to participate in its growth. At the same time, there have been other periods when investors attempting to avoid losses from market downturns would ideally have had less market exposure.

Historically, positive daily market changes have slightly outnumbered negative ones. However, large daily movements are more likely negative than positive. This phenomenon can also be observed over longer periods of time. As seen in *Figure 3*, major downturns like those in 1987, 2000 and 2008 (shown in red), have tended to be more sudden and violent than the upturns. This suggests that periodic

adjustments to asset allocation may not be sufficient attempts to protect investors, especially in times of high volatility and high asset class correlation. In such environments, market exposure may be as important a factor in investment results as security selection.

Figure 3 Frequency and Severity of Market Downturns



Source: Standard & Poor's, Forward Management, LLC

Our conclusion: To participate in equity market growth while sidestepping most impacts of market downturns, investors may want to consider the practice of **active asset allocation**, defined as **continuous, nimble management of market exposure**. We believe that in a time of market volatility, this principle of active allocation can aid investors in their effort to earn strong, absolute returns while attempting to lower the risk of investment losses.

Forward Tactical Growth: Nimble and Flexible at the Core

Forward's Tactical Growth strategy is an equity-oriented approach providing continuous management of market exposure. It seeks to outperform most traditional equity strategies by capitalizing on both positive and negative market movements. This is accomplished by:

- ▲ Increasing equity exposure when the team believes risks appear low.
- ▲ Taking neutral cash positions when they believe opportunities appear unclear.
- ▲ Creating inverse market exposure when they believe that risks of a significant downturn are relatively high.

Unlike many other equity-oriented strategies, Forward Tactical Growth seeks to eliminate stock-specific risk by investing in highly liquid index investments, ETFs.

Forward Tactical Growth can thus play several roles in investor portfolios. It is unusually adaptable to investors' preferences and comfort levels with the market, as well as to advisors' varying views of the market.

How the Strategy Fits

Forward Tactical Growth's risk/return characteristics make it suitable for varying roles in investor portfolios.

- 1) **A new kind of core strategy** bringing flexibility and an absolute return slant to core holdings.
- 2) **A risk cushion** that applies market-risk management to a share of portfolio assets.
- 3) **An alpha-seeking strategy** that resides alongside satellite and alternative approaches.

Moving as the Market Moves

The Forward Tactical Growth strategy seeks to add value to investor portfolios by incrementally adjusting market exposure as market conditions change. The strategy is highly flexible in managing long and short exposures with no constraint on cash holdings.

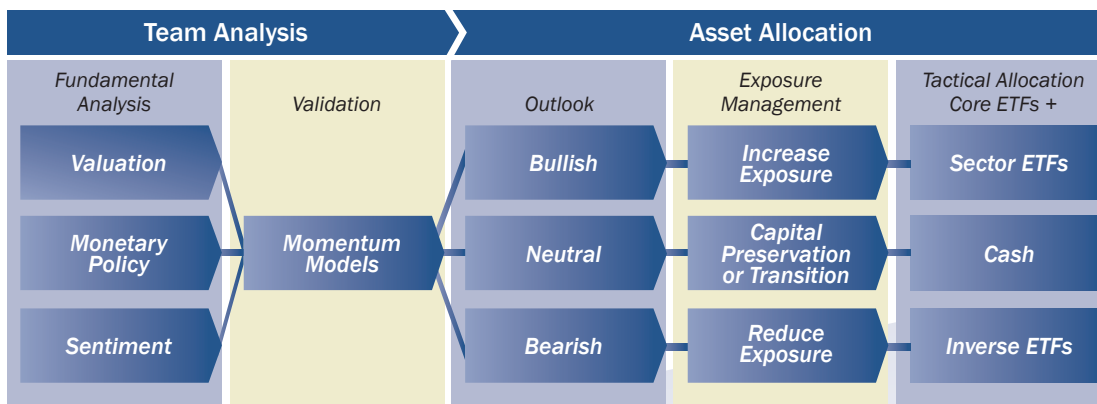
In contrast to market timing approaches, which attempt to predict the market's direction, Forward Tactical Growth waits for a trend to be established, looks for clear signals and then seeks to capitalize on the market's direction.

It is not a "black box" approach; rather, it employs a disciplined, repeatable process relying on the investment team's judgment, based on both qualitative and quantitative analysis [Figure 4]. The qualitative component, which guides the team's assessment of market trends, takes into account a variety of macroeconomic factors including:

- ▲ Market valuation
- ▲ Monetary policy
- ▲ Velocity of increases or decreases in market liquidity
- ▲ Investor sentiment (from a contrarian perspective)

The quantitative component, which validates or conditions the team's qualitative assessment, utilizes a proprietary Volume/Breadth Momentum Model.

Figure 4 Overview of Forward Tactical Growth Investment Process



Investment Team

The Forward Tactical Growth strategy was developed and is managed by Broadmark Asset Management, sub-advisor for the Forward Tactical Growth strategy. The Broadmark investment team has worked together for more than a decade and has employed the Tactical Growth strategy since 2001. The strategy derives from team members' experience with market cycles over more than 30 years and has been backtested for historical accuracy.

How Active Allocation Differs from Traditional Core Investing

	Traditional Core Strategy	Active Allocation Strategy – Forward Tactical Growth
<i>Objective</i>	<i>Relative return – meet or beat market benchmark</i>	<i>Positive absolute returns</i>
<i>Value added</i>	<i>Security and sector allocation</i>	<i>Management of market exposure, including sector weighting</i>
<i>Portfolio construction</i>	<i>Bottom up</i>	<i>Top down based on macroeconomic perspective</i>
<i>Risk management</i>	<i>Broad diversification with full investment – Minimize deviation from benchmark</i>	<i>Sector diversification with flexible investment – Capitalize on upside volatility, sidestep downside</i>
<i>Use of cash</i>	<i>Bias or mandate to be fully invested</i>	<i>No constraints</i>
<i>Shorting</i>	<i>None</i>	<i>As conditions warrant</i>
<i>Financial leverage</i>	<i>None</i>	<i>None</i>

Conclusion

Many investors are still reeling from major losses in the 2008 market decline and the realization that they've made little or no progress toward their long-term goals over the last decade. As a result, many now find themselves torn between their desire to participate in the market's recovery and their fear of another downturn. At the same time, many investors are seeking sound ways to pursue absolute return while coping with market volatility.

The Forward Tactical Growth strategy is an innovative and timely approach aimed at bringing resilience and return potential to core holdings. This new option may help investors re-enter or remain in the market with greater confidence.

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