

THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

Relative Value Investing & Tactical Asset Allocation



RICK VOLLARO, CPA, joined Pinnacle Advisory Group, Inc. in 2000 and became a partner in 2008. He works with the investment team as Pinnacle's Portfolio Manager. In this role, Rick works directly with the Chief Investment Officer to construct the firm's macro-economic forecast, set portfolio strategy, and assist with asset allocation and individual security selection. Rick's work includes top-down macro-economic research, domestic equity sector analysis, market capitalization strategy, and portfolio risk management. Rick briefs the Pinnacle Investment Committee on changes in investment strategy, and writes investment

articles for the Pinnacle website. He has bachelor's degree in accounting from Fairfield University and is a non-practicing Certified Public Accountant in the State of New York.

SECTOR – GENERAL INVESTING

TWST: Would you start with an overview of Pinnacle Advisory Group and what you do there?

Mr. Vollaro: Pinnacle Advisory Group is a wealth manager, and our mission is to provide the best of both financial planning as well as tactical money management. We currently serve over 600 clients and manage nearly 700 million of client assets. When our clients first come on board, they typically start out working with our wealth managers, who give them a comprehensive financial checkup. Our planners combine quantitative and qualitative analysis of a client's financial health with the risk tolerance of the client, and those inputs allow our planners to pick out the appropriate investment policy for our clients. At Pinnacle we run five different dynamic models that range from ultra conservative to ultra aggressive. The models we run are called dynamic because they will move in real time based on the view of our investment team. This is different than many planning-based firms that follow modern portfolio theory and believe in strategic asset allocation. At Pinnacle we do a lot of homework to come up with a view, and that view is the basis for our allocation at any given point in time.

I'm currently the Portfolio Manager for two of our models and the Senior Analyst on the remaining three. I also hold a minority equity interest in the firm, and serve in a management and executive capacity.

TWST: Would you take us through the process beginning with asset allocation?

Mr. Vollaro: There are a few different points to be made. First off, I want to make clear the type of money manager that we are, and as part of that process also help clarify what we aren't. We are relative value managers, which means our model portfolios each have theoretical benchmark portfolios that define the risk and expected returns parameters of each model over a long-term time horizon. It is our job to beat those benchmarks over time, with less risk than simply owning the benchmark. Our benchmarks are composed of varying percentages of the S&P 500 and the Barclays Aggregate Bond Index. Tactical can also be a very ambiguous word, so let me define what tactical means for us. Tactical means we have the latitude to change our broad allocations and move the percentage weightings we own in equity, fixed income and alternative investments. It also means we have freedom and flexibility to buy what we want at the intra-asset-class level. We can attempt to add value by moving in and out of

equity sectors and industries; we can target different levels of market beta, credit qualities and duration of fixed income markets. And we are always on the hunt for unique or eclectic managers and strategies that we believe might make good alternative investments. Lastly, our bottom-up analysis on each security we own should lead us to selecting the highest-quality securities within the universe we are targeting. That bottom-up analysis looks at construction, expenses and liquidity.

Our dynamically changing view of the world is paramount in adjusting our portfolios, and so we put a heavy emphasis on continually adjusting our outlook by doing a lot of homework on macroeconomic fundamentals, technical analysis and traditional valuation metrics. These three building blocks lay the foundation for our market views and forecasts. The macro fundamental work we do focuses on consumer spending, housing, leading indices of growth, earnings, interest rates, currency, monetary and fiscal policy, and other measures of cyclical business cycles. Technical analysis combines elements of trend analysis, momentum, mean reversion and market sentiment. Our valuation work is comprised of traditional metrics, such as price to earnings, price to book, a number of interest rate-based measures and intrinsic value.

An exhaustive amount of work goes into forming our view. And once we have set it, we then have to express our outlook through the asset allocation of the portfolios. The amount of conviction that we have in our view will dictate how far we allow

Let me give you an example of how this works: Heading into the latest economic contraction, we had a lot of conviction that we were going to see a downturn. Back in mid- to late 2007, we were watching consumer spending tick down, housing was decelerating fast and the credit markets were beginning to show cracks in the system. As we looked at the world, we thought a recession was likely on the horizon. That thought led us to begin down shifting our portfolios during the fourth quarter of 2007, mostly by buying defensive sectors, like staples and health care, and keeping quality high in our fixed income allocations. So we were defensive but not overly defensive yet. However, during January of 2008, the technicals continued to break down in conjunction with the fundamentals, and we got even more convinced that our view of a recession was beginning to unfold and that a bear market was upon us. The strong conviction we had at that time led us to a much more material allocation shift, which at the time reduced a very large amount of equity from our portfolios. I'm talking about a moderate portfolio that would normally have around 60% equity was moved down to around 25% in equity. That's the kind

of material move I'm talking about, should we have a lot of conviction in our view. Note that we would never remove all of our equity exposure, as we believe that would be tantamount to having 100% conviction in our view. We don't believe anyone should believe that convinced, so material to us does not include going 100% to cash or stocks.

Highlights

Rick Vollaro says that at Pinnacle he runs five different dynamic models that range from ultra conservative to ultra aggressive. These are dynamic models because they will move in real time based on the views of the investment team. Tactical means that he has the latitude to change the portfolio's broad allocations and move the percentage weighting owned in equities, fixed income and alternative investments. He has the freedom and flexibility to buy what he wants at the intra-asset class level. He is always on the hunt for unique or eclectic managers and strategies that might make good alternative investments. His bottom-up analysis on every security should lead to the selection of the highest-quality securities by looking closely at construction, expenses and liquidity. Since the portfolios are constantly adjusted according to changing markets, he focuses his outlook with due diligence on macroeconomic fundamentals, technical analysis and traditional valuation metrics. These three building blocks lay the foundation for his market views and forecasts. Right now, he does not have a lot of conviction in the markets and is therefore sitting around benchmark volatility in most of the portfolios and it is probably safe to say that we are getting closer to an inflection in the stimulus cycle. He will not make any big bets until there is more clarity about where the economy is headed.

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ourselves to get off the benchmark portfolio at any given time. When we have a lot of conviction, we give ourselves the flexibility to deviate materially from the benchmark. And when we don't, we stay tighter to our benchmark.

Fast-forward to today, where we don't have a lot of conviction in our view and therefore are sitting around benchmark volatility in most of our portfolios. We actually think the current forecast is very ambiguous at the moment. We've had an unbelievable run off

the bottom, 60% plus since last March, and it's been driven mostly by liquidity and backstops. It's probably safe to say that we are getting closer to an inflection point in the stimulus cycle. It seems clear that over this year, some of the stimulus and liquidity will come out of the system. As it is removed, what's in question is whether or not the economy is now healthy enough for a self-sustaining cycle to begin to take hold within the economy. This lower conviction view has us tighter to the benchmark currently, as we don't believe there is a reason to make a big bet until we have a little more clarity about where we are headed from here.

The way we manage money is great in terms of giving us flexibility to own what we want and find the best value we can, but it does create some complexity in terms of risk controls. There are two ways we currently deal with that complexity. First off, we monitor each position on a volatility basis. When we look at volatility, we worry less about whether a position is called equity or fixed and more about how much volatility is inherent in the position. A good example of this would be high-yield bonds, which we started buying very close to the equity lows. When credit markets shut down and yields got close to 20%, we liked the value and potential for total return so much that we started buying high-yield bonds in lieu of equity positions. And it turns

Mr. Vollaro: We think that it really gives us a structural advantage over the investors that are strategic in nature. That doesn't mean that we're always going to be right in our tactical moves, but we think that if we do the homework and are willing to expend the money, time and effort to do it right, then it would be a crime not to move our portfolios in tandem with changes in the market environment. Philosophically we believe in the value added from this strategy, and we have invested as a firm for the better part of a decade to come up with the best way to manage money in this fashion. After a lot of sweat equity and tangible costs involved, we believe we have come up with a repeatable process that clearly adds value to our client portfolios over time. Despite our thoughts on the subject, much of the wealth management industry that we compete against has really held on to some old economic theories. As a firm philosophy, we don't believe that modern portfolio theory is on very solid footing. Some of the theories are old or outdated, and some may just be misinterpreted. Anyone that is a believer in strategic management should read *Buy and Hold is Dead Again*, which is a book written by our CIO, Ken Solow. Ken spends a lot of time in the first half of the book explaining why much of the basis of modern portfolio theory is either misinterpreted, outdated or incorrect.

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out that even though they are debt, the volatility of these positions were as high as many of the equities in the portfolios, so they were considered to have 100% equity-like volatility characteristics when viewed from a risk perspective. Last year that worked in our favor, as high yield was among the best asset classes to own during the run-up.

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TWST: How would you describe the advantages of tactical asset allocation over strategic asset allocation, which is practiced at so many traditional money managers?

TWST: Another advantage of your tactical asset allocation is that volatility helps your investment process. Did you take advantage of opportunities in the market in the last year?

Mr. Vollaro: Absolutely. We took advantage of a number of different asset classes within both the equity and credit markets. One of the places that we thought had the most compelling value during the height of the economic crisis came on the fixed income side of the ledger. There was a time that high-yield bonds and a select part of the mortgage markets had literally blown out based on credit market problems. High-yield bonds yielded roughly 22% over treasury bonds at the height of the crisis, and some of the private label mortgages on the street were trading at 20 or 30 cents on the dollar. These instruments were essentially discounting not only a deep recession, but a depression. We loved the value in these areas and felt that with the amount of global stimulus being thrown at the problem, these markets would be winners if the systemic risk could be taken out of the system through the globally coordinated efforts of governments and central banks. Throughout the recession and financial crisis, we steadily built up heavy positions in different segments

of the credit markets, and that corporate and mortgage exposure really turned out to be a huge win in 2009.

Within the equity universe, we both increased our allocations to equity and rotated around what we owned as well. We rotated out of the heavy overweights we had in defensive areas like staple and health care, and into cyclical sectors and industries that we thought would benefit the most from monetary reflation.

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The theme we bought into at the time is what most investors would call the “reflation trade.” We were sitting on the precipice of a great experiment at the time where a debt deflation was unfolding, and essentially the government decided it was going to pull out all the stops. To stop the deflation the governments of the world united and embarked on a globally coordinated stimulus campaign. The U.S. Fed led the way by creating a number of special liquidity programs, bringing rates down to 0%, and printing money and buying securities, otherwise known as quantitative easing. Most of the efforts were clearly targeted to stimulate the flow of credit in an effort to jump-start consumer spending. The international community was also doing its best to stimulate demand. And so our thesis was that the campaign worked directly into the favor of the most cyclically sensitive and the most beaten-up areas of the market. With the proceeds from defensive areas, we began purchasing materials, emerging markets, energy service companies, technology and some small-capitalization exposure. Now in hindsight, one thing we could have done better

TWST: What about the other side? What are you deliberately underweighting ?

Mr. Vollaro: Given our lower-conviction forecast at present, I can’t say that we’re completely abandoning anything at the moment. We don’t have a whole lot of quality bonds with high duration within our fixed income allocations since the value is less than compelling. But do we have some exposure, mostly

as a hedge against a resumption of deflation. We still have very small positions at this time in the financial sector of the equity markets. We had virtually no exposure to this sector during the majority of the great meltdown, but we did put a small position as the sector stabilized, and we’ve tried to take advantage of the business cycle, mean reversion, government backstops and a steep yield curve. All of these things may be decent cyclical drivers for financials, but we still are concerned about the secular story for the sector. It’s probably going to be an area going forward that’s much more regulated. And recently the Obama administration is beginning to propose some taxes and potential changes in structure that may present headwinds to the future of profitability in this sector. So financials are still not an area that we think is worth over-owning. Cash would be another asset class we have been avoiding lately. This is not rocket science, since no one wants to own a whole lot of cash when it’s paying virtually 0%. Rates at emergency levels has contributed to the cash-is-trash mentality lately, which is not particularly a great

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was to be a little more aggressive in moving up the amount equity in our portfolios. We essentially went from underweight to around neutral allocations. We didn’t dial things up all the way due to structural concerns we still had regarding the global economy. As it turned out, just moderate shifts in allocation, heavy sector rotation and a big credit bet were enough to propel most of our models to benchmark-beating years in 2009.

thing from a sentiment perspective, but it is the logical reason that we aren’t holding much cash in our portfolios. That doesn’t mean we don’t hold any cash, and during brief periods we have built a little cash. But it usually is considered dry powder for future positions in other asset classes, and it doesn’t sit around long.

TWST: What about other themes for 2010 — international, China infrastructure, for example?

Mr. Vollaro: I'll start with our view that we're close to an inflection point here. If you look at the rally we've had off the bottom, the market really started by rallying on nothing more than less bad news for a while. Ten months later and after mountains of liquidity have been poured into the system, the trend of the economic data has improved markedly, and the financial markets have experienced healthy gains off the bottom. We think the combination of low expectations, improving data and no inflation created a sweet spot that supported risk taking and fueled the torrid rise in risk assets. Now that being said, it seems like we may

being generated. A lot of the earnings that have been generated over the last two or three quarters were based on cost cutting and what we've seen is tremendous surprises in earnings. What we haven't had yet is a lot of absolutely good earnings. But if sales begin to pickup, higher earnings may be on the horizon. The best case scenario would be to have a positive feedback loop form. In other words, if confidence is beginning to pickup, we could get into a virtuous cycle here. That would be where increasing confidence leads to more spending, spending leads to better earnings, higher quality earnings leads companies to hire

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be getting closer to a place where the monetary authorities will begin to pull some of the emergency measures off the table. Less stimulus, or even the idea of less stimulus, is what sets up the inflection point. As stimulus begins to come out of the system, there are several scenarios that could take place. The bear camp would say the entire improvement in growth that we've seen in the economics and financial markets has been driven by stimulus. We just wrote about this in our quarterly outlook, and to describe the story we used an anabolic steroid analogy. The economy was weak and deflating, and the authorities pumped it back up with a whole bunch of drugs. That's great for a period of time, but as soon as the sugar high wears off, we should expect the return of weakness. What the bears are saying is that there is no organic demand driving top-line growth in sales, but instead only a struc-

ture of more employees and increase wages, and ultimately that feeds back into a further increase in confidence, and the cycle is on. This would be the best case scenario, and could take this cyclical bull market higher than most currently think. Neither of these scenarios make up our base case at the moment. Our best guess right now is that a combination of inventory restocking, stronger exports, and excess liquidity should keep some upward pressure on economic numbers and should allow the financial markets to grind higher over the next quarter. Our stated market outlook for the last few quarters has been that the market will probably drift into the 1,200 to 1,300 range on the SP 500, and we are sticking with that target range as our highest probability right now. As we wait and watch the data unfold, we are positioned around benchmark weightings. Even though it's hard

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turally weak system that has been entirely supported by taxpayer money. If the bears are correct, then we could have some problems in the financial markets at any hint of stimulus withdrawal.

On the other hand, a self sustaining economic cycle cannot be ruled out at this point either. Over the last 6 months a wide swath of global economic data has gotten better. What we're really looking for here is consumption and sales to start

to control the urge to make moves in our portfolios, we feel this is one of those times that it probably makes more sense to do less trading here, and more watching and weighing the data that's coming in before we make our next big move. Should we get to our target zone, our current plan is to be rotating out of many of the more cyclical and deflation based trades that we had put on over the last 6 months or so.

As to international growth I'll start with China and the emerging markets. It's fair to say that growth in the developing world has been a whole lot better than growth in the developed countries of the G-7. The question for these markets has to do with whether things are getting stretched now. Domestic markets were up in the 60% range, but many of the emerging markets have run over 100% off the bottom, so we've had some really big moves out of that part of the world. Certainly the growth rates have been there and the fundamentals are better in terms of the

really helpful in conjunction with the business cycle research we do. We've found that certain parts of the cycle typically line up well with certain sectors and industry groups. As an example, we might own pharmaceuticals if the business cycle is decelerating, technology when we think we are exiting a recession, or materials or energy as a late cycle play that normally works in line with strong capacity utilization that has typically built up by the end of a cycle. ETFs have some advantages relative to mutual funds. You can trade them all day long as they move in

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savings rates and external surpluses versus our deficits. In China's case, due to the structure of their political system, they were able to put their stimulus to work much quicker than we did. But despite the great structural story, the emerging markets are hardly risk free. There's one school of thought that says an overbuild is occurring right now, and some are questioning whether or not another boom/bust scenario may be building in the Chinese property markets. This is creating some concern right now that Chinese policy makers may proactively begin to raise rates or the currency value in an attempt to avoid falling into a housing debacle like we had domestically. Lately the Chinese have begun to tinker with reserves requirements and their markets have become more volatile over the last few weeks.

tandem with the markets. Intraday pricing is particularly helpful in very volatile markets, because it allow us to use the volatility to our advantage as we enter and exit positions. Additionally, ETF execution pricing is typically very reasonable, the expense ratios are quite low, and there are some tax efficiencies built into the structures of most exchange traded funds. They are not without risk, and the more issues there are available, the more the buyer must be aware of how they are constructed. Some securities hold very concentrated positions, and the volume traded is not equal by security either. Furthermore, ETF's are not great vehicles for dollar cost averaging. We believe the benefits outweigh the negatives for the way we invest, so we use quite a bit of exchange traded funds in our portfolios.

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TWST: I wanted to ask you about ETFs, Is that something that you're still looking at?

Mr. Vollaro: Absolutely. We use a lot of exchange traded funds (ETFs) in our portfolios, and I would say we're getting the most of bang for the buck using them for equity sector rotation. At this point, all 10 sectors of the S&P are available, and there is a growing universe of industries as well. We find them

TWST: What distinguishes your investment approach at Pinnacle from that at peer companies? What do you bring to the table that others might not when it comes to relative valuation and tactical asset allocation, for example?

Mr. Vollaro: If you want to differentiate us amongst most of our competitors, a lot of our competitors just don't tactically asset allocate. As I said before, there are a lot of wealth

managers that will simply look at the universe of investable securities and draw up a list of what they think is the efficient market. They'll buy that portfolio and then if markets go up or down, they'll simply rebalance to their targets and be pretty happy to do that. Many of these shops are believers in the efficient market theory, and I think there have been plenty of examples of why markets should not be viewed as efficient over the last few years. Whether you look at the new-paradigm thinking that led to the tech wreck or the decoupling theory for commodities, or emerging markets that crashed and burned, there are just an incredible amount of examples out there to show you that markets really aren't that efficient, and that you do need to pay attention and adjust portfolios for changes in market values and changing conditions. It would seem to me that folks are probably beginning to get fed up with the efficient market crowd. So as I stated prior, just the fact that we have a tactical product that gives us the chance to move the allocations around based on our view is structural advantage number one.

Along with a structure that takes advantage of our philosophy, you also need a repeatable process. We've worked on this process for the better part of 10 years. And while we are always tweaking and looking to get better, we think the process we have now is repeatable and will continue to add value over future market cycles.

You also need great people to run a successful money management operation, and we think our team is top notch. Ken Solow, myself and Carl Noble, our Senior Portfolio Analyst, have been together for about a decade now, so the core of the team is strong and experienced.

Once you get past philosophy and structure, process and people, it simply comes down to execution. So far we have been able to execute over a number of market cycles. We caught the 2003 to 2007 bull market, stepped out of the way of the latest downturn through March of 2009 and turned more aggressive for the current cyclical bull we have enjoyed off the bottom. I think over time we are proving we can execute our strategy, and the numbers say we have added value for our clients.

TWST: Thank you. (PS)

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