CAPITAL STRATEGIES
FINANCIAL CORPORATION
Navigating Financial Security

How We Manage Money

Capital Strategies has developed a close working relationship with Trademark Financial Management LLC, one of CSFC's Strategic Alliances. We do this by working together with Trademark Financial Management LLC as a team when deciding how to manage CSFC clients' assets. We start this by creating a strategic core of assets to be held in all market situations with very modest adjustment, and then adding a more tactical overlay around it. We use mutual funds and exchange traded funds (ETFs) almost exclusively, because we are interested in obtaining the market return for specific asset classes (large capitalization stocks or investment grade corporate bonds, for example) while minimizing the specific risk of any particular company.

In other words, while we will always have a large company stock fund with a value orientation in our portfolios (a core asset class in our way of thinking), we will often not own an emerging market stock fund (which we consider a tactical idea). We create each core based upon the risk parameters, time horizon, income needs, and tax sensitivity of each client. We like to use an Investment Policy Statement[1] to make sure we are in agreement with our clients on those key areas.

In terms of how we select individual holdings, we look for low cost ETFs to get exposure to the core of the portfolio. This means blue chip, dividend paying domestic and foreign stocks and high quality government and corporate bonds. We will supplement the core with mutual funds in which we have a high respect for the skill of the manager or management team. We will also use more active ETFs that might target a specific segment of the stock market, say low volatility stocks of high quality (strong balance sheet).

For the tactical "explore" part of the portfolio we will look to overweight areas of the market that are attractive from a value standpoint and/or a relative strength standpoint. This is where we might look at sectors such as real estate or utilities or technology, for example. We might look at a preferred stock fund or ETF. We might look at small cap foreign stocks or emerging market or high yield debt. We might look at a fund with an alternative source of return, such as a merger arbitrage mutual fund. Then again, there are times when we don't find very much that is tactically compelling. In those cases we won't hesitate to raise the cash in the portfolio to 15% to 20% or more.

When we choose individual holdings, we are looking for consistent management skill and reasonable cost. Of course, when we buy an S&P 500 Index ETF for example, management skill does not come into play. Core ETFs are purely about owning the asset class as inexpensively as one can. For actively managed funds, we work very hard to find managers who have demonstrated superior risk-adjusted performance over multiple market cycles. It is not about today's hottest hand, because those who shoot for the top can easily find themselves on the bottom when market conditions reverse (as they inevitably do). Instead, we pay attention to a fund's capture ratio (percentage of upside capture in a bull market phase versus its percentage of down market capture in bear phases).

We are looking for a consistent ability to deliver more return per unit of risk in strong markets (exemplified by funds such as PRIMECAP Odyssey Aggressive Growth) and funds with a consistent ability to deliver lower risk per unit of return in weak markets (such as First Eagle Global). We believe that we have added value over time through superior fund selection. We also pay attention to the Sortino ratio, or the downside volatility of a fund relative to the risk-free rate. This avoids punishing funds for upside volatility.

Overall, our belief is that the core holdings prevent the portfolio from having a large tracking error relative to the benchmark we agree to. The tactical overlay is where we use our expertise to either enhance return or reduce volatility.

1 An Investment Policy Statement is an agreement between the investment manager and the client which spells out the objectives of the portfolio and the latitude the manager has in terms of meeting those objectives. Typically the IPS provides for a benchmark the portfolio should target and a list of acceptable types of securities (or unacceptable types) the manager can use in order to meet the portfolio's objectives.