Discretionary Risk-Managed Relative Strength Portfolios

We use academically-studied, real world-applied quantitative rules-based techniques to select asset classes and market segments for investment in order to seek to achieve superior risk-adjusted results for our clients.

For the past four decades, the Portfolio Management Group has addressed the needs of high net worth individuals and institutional clients, creating customized investment strategies, portfolios and solutions. Our portfolio managers represent a select group of Financial Advisors who are qualified by the firm to manage your assets based on training, experience and commitment to client service. They bring a disciplined approach to managing your portfolio and a focus to investing.

Your portfolio in the Portfolio Management program is designed to help meet your specific financial needs and is managed on a fully discretionary basis by your Portfolio Manager. Leveraging the global resources of Morgan Stanley, your Portfolio Manager monitors the events that affect your financial objectives. He or she also studies trends and developments that shape the investment environment, drive the economy and ultimately impact your portfolio's performance. You'll find that your Portfolio Manager's experience, training and investment philosophy offer guidance—both in ongoing portfolio management decisions and understanding investment risk while keeping your long-term goals in view.

Your Portfolio Manager works closely with you to understand your needs while maintaining the focus and discipline necessary to guide your portfolio in the most challenging market cycles. A disciplined four-step investment process underpins the program and helps to develop a long-term perspective about building and managing wealth.

Objective

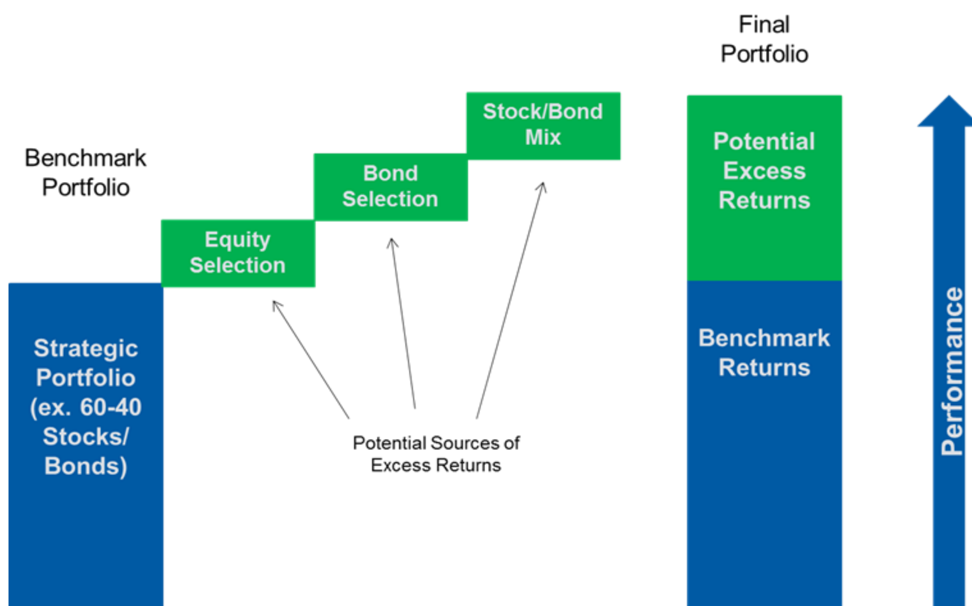
The objective of this investment strategy is to adapt the portfolio to the opportunities presented in the market on a dynamic basis. Our portfolios are designed with the goal to grow when growth is available, but also to manage risk. This is intended to provide the investor the potential to capitalize on shorter term trends, realize increased gains, limit volatility – particularly downside volatility, and provide risk management. By reducing exposure to various assets in prolonged declines, we intend to reduce portfolio risk, reduce exposure to capital loss, and thereby establish a structure intended to provide long-term sustainable growth. This may be attractive to investors who desire an approach that seeks to navigate market risk and volatility on a dynamic basis. (See Disclosures for a discussion of risks.)

What Are We Trying To Achieve?

Our goal is to generate positive Excess Returns[1] for our clients, which are returns better than benchmark returns. Our pursuit of excess returns starts by delineating the challenge as depicted in Figure 1.

We begin by considering a Strategic Portfolio; a buy-and-hold portfolio with a specific stock/bond mix, for example a 60%-40% stock/bond mix. We expect it to deliver benchmark returns comprised of 60% from the benchmark stock index and 40% from the benchmark bond index. By definition, the strategic portfolio does not deliver excess returns above (or below) the strategic benchmark.

Figure 1: Pursuing Excess Returns in Portfolio Construction



Our research suggests that returns above the benchmark returns (i.e., positive excess returns) are reasonably possible[2]. Again referring to Figure 1, we seek excess returns above the benchmark in 3 areas: Equity Selection (better stocks than the benchmark), Bond Selection (better bonds than the benchmark), and a better stock/bond mix than the benchmark. An example for each follows.

Considering equities, let's assume that the equity benchmark is comprised of approximately 50% US stocks and 50% non-US stocks (the "MSCI All Country World Index [ACWI]" is similar to this). Now let's also imagine the markets are in a period where US equity consistently outperforms non-US equity. We intend for our equity selection analysis to identify this state of affairs so that portfolio assets may be tilted to US equity in to order take advantage of the opportunity. Yet, when the environment changes and non-US equity is favored, we intend for our equity selection analysis to make this adjustment.

Considering bonds, let's assume that the bond benchmark is comprised of US bonds of high quality and medium duration (the "Barclay's Aggregate Bond Index" is similar to this). Now let's also imagine that the economy is in a period of rising interest rates. In a rising rate environment, bond prices tend to fall and short duration bonds tend to perform better than medium duration bonds. Also, in a rising rate environment, certain bonds of bank loans might be expected to rise in price. We intend for our bond selection analysis to identify this state of affairs so that portfolio assets may be shifted to take advantage of the opportunity. Yet, when the environment changes and other parts of the bond market are favored, we intend for our bond selection to adjust accordingly.

Considering the stock/bond mix, in strong equity markets, investors would be expected to enjoy the portion of their portfolio that is in stocks, say 60%, but maybe not appreciate the portion of their portfolio in bonds, say 40%, that might be underperforming stocks. In weak equity markets, it may likely be reversed; investors might appreciate the 40% of their portfolio that is in bonds, but not the 60% in stocks that may be performing poorly. We pursue positive excess returns, in part, by varying the stock/bond mix. We seek to increase the percentage of equities at the expense of bonds during strong equity markets. Conversely, in poor performing equity markets, we would seek to decrease the percentage of equities in the portfolio and increase the percentage of bonds (and cash)[3].

It is important to note that excess returns may be positive or negative at any point in time. Of course, realizing positive excess returns through these "better" techniques is highly dependent upon having the analytical tools to identify opportunities and having the discipline to act.

How Do We Do That?

In the paragraphs above, we used words like "tilt", "shift", and "increase/decrease the percentage of…" to describe actions that would be desired in a portfolio to take advantage of an opportunity or to avoid an undesirable outcome. But what can give us the conviction necessary to make changes to a portfolio and then to reasonably expect a positive outcome?

We use an investing technique called Relative Strength[4] to help us identify near-term investment opportunities. In essence, we seek to buy strength with the assumption that recent strength, on a relative basis, will continue in the near-to-intermediate term. This technique is applied to all areas where we seek excess returns: equity selection, bond selection, and stock/bond mix specification. An overview of our process is depicted below in Figure 2.

Figure 2: Constructing Risk-Managed Globally Diversified, Relative Strength Portfolios

We divide our portfolios into multiple sleeves; or mini-portfolios. Each sleeve has an investment purpose, and most are chartered to pursue excess returns. To illustrate, we will consider an equity sleeve as an example.

In steps 1 and 2, we identify an investable diversified sleeve. For example, we will use US equity sectors. We identify nine investable sectors creating a diversified sleeve (Technology, Materials, Financials, Utilities, Industrials, Healthcare, Energy, Consumer Staples, and Consumer Discretionary).

In step 3, we apply a strength screen to the nine sectors. We do this by mathematically calculating the strength of each sector security and then ranking them from strongest to weakest. Our

rules-based system specifies that we select for investment consideration the strongest from the list. The conservative nature of our process would have us, eliminating the weakest sectors instead of relying on the best 1 or 2 sectors.

In step 4, we apply a Risk Management Screen to the selected sectors. An outgrowth of our Relative Strength calculation is that we can garner some insight into whether any particular security is expected to give us positive or negative returns in the near-to-intermediate term. In this step, we eliminate from investment consideration any security that we reasonably believe would produce negative returns in the near term. Capital that would otherwise be allocated to such a security would then be invested in a bond/cash type instrument. All securities that pass the Risk Management Screen would then be marked for investment. The process of identifying portions of the portfolio that can be either in stocks or bonds is a significant part of our process to adjust the stock/bond mix, and adds to our ability to provide a measure of downside protection.

In step 5, because of the rigor and discipline in steps 1-4, we invest with conviction with the belief that, over a reasonable period of time, our process is likely (but not guaranteed) to generate positive excess returns.

In addition to the quantitative methods described above, we also use fundamental research to aid in our security selection. We analyze many factors including, but not limited to: historic correlations between asset classes and repeatability of the same, tracking error, liquidity, bid/ask spreads, internal expenses, manager consistency, and longevity of tradable securities.

Putting It All Together for Our Clients

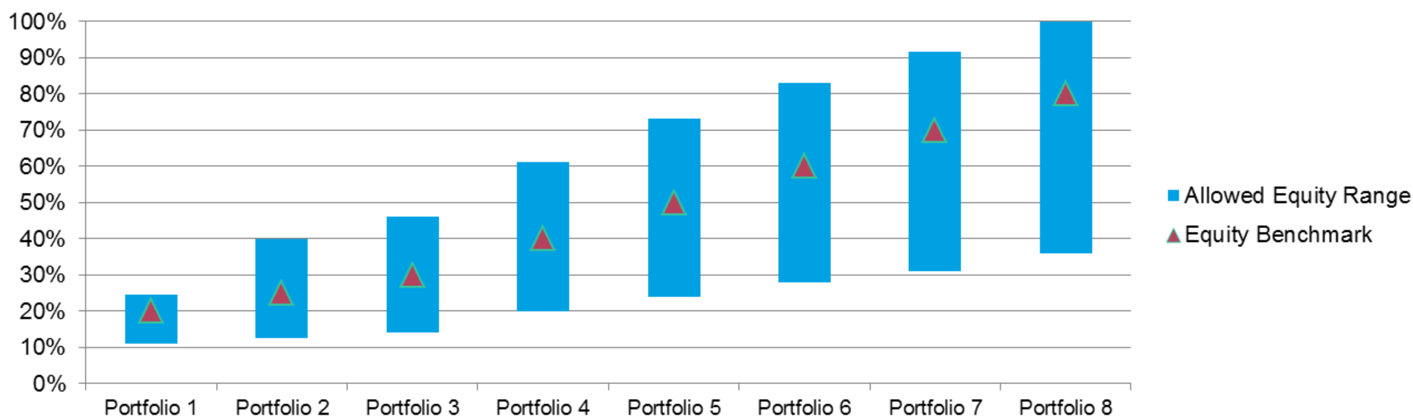
We described above our process for a single equity sleeve. We replicate that process over other parts of the equity market, bond market, alternatives, etc. often using 8-10 sleeves to construct a portfolio. We use variations in each sleeve, but adhere tightly to the Relative Strength discipline. The objective of multiple sleeves is to pursue desired *portfolio* behavior. No investment strategy can be expected to succeed all the time in all time frames. By incorporating multiple sleeves, we can allow some sleeves to temporarily underperform while other sleeves, hopefully, exhibit outperformance. Multiple sleeves also gives us multiple points of control to incrementally adjust position weightings from the bottom-up as opposed to making large top-down investment decisions. This ability to adjust in small incremental amounts is a key reinforcing element in our pursuit of investing with conviction.

Relative Strength portfolio construction is both an art and a science; it is simple but not easy. Buying strength is a simple concept; bringing it all together into a well-behaved portfolio over a long period of time is not easy. Doing the mathematical relative strength calculation is very scientific; but constructing, combining, and weighting sleeves is very much of an art. It is at this very point that we bring together our combined 35 years of experience in the financial industry, our degrees in engineering and finance, and the resources of Morgan Stanley – all for the benefit of our clients.

Portfolio Options from the Renaissance Group

We currently offer 8 portfolios utilizing our Risk-Managed, Globally Diversified, Relative Strength approach as shown in Figure 3 below. (See note 5 below.)

Figure 3: Risk-Managed, Globally Diversified, Relative Strength Portfolios from the Renaissance Group



To read the chart in Figure 3, consider Portfolio 6. This portfolio maintains a 60-40 stock/bond benchmark. Many portfolios, both custom and model-based in the financial industry might implement a 60-40 benchmark portfolio such that the mix is *always* 60-40, or close to it. We can even expect many to brag about this touting rebalancing to keep the mix in place. However, our Portfolio 6 portfolio

allows the equity to rise to approximately 82% (very useful for strong equity markets). Conversely, the model allows the equity portion to decrease to less than 30% of the portfolio (very useful for weak equity markets, bear markets, and downside protection).

Our Commitment to You: As your Wealth Management Team, we want to find out about you, the kind of lifestyle you enjoy, what you want to accomplish for you and your family, what worries you and what you're passionate about. And, we want to help you reach your overall wealth management goals.

"…doing only first class business in a first class way…" **J. Pierpont Morgan**

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Notes:

1. Source: https://www.investopedia.com/terms/e/excessreturn.asp
2. Our research is centered on Relative Strength and Momentum investing. Academic research abounds; however, several recent papers are: "A Century of Evidence on Trend-Following Investing" by Hurst, Ooi, and Pedersen. Another is "Time Series Momentum" by Moskowitz, Ooi, and Pedersen.
3. When considering decreasing equity exposure in poor performing equity markets, we tend to be concerned only with the most severe downturns.
4. Relative Strength is a measure of the price trend of a stock or other financial instrument compared to another stock, instrument or industry. https://www.investopedia.com/ask/answers/06/relativestrength.asp
5. Allowed equity ranges and equity benchmarks may change, without notice, at the discretion of the Renaissance Group.

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This material is intended only for clients and prospective clients of the Portfolio Management program. It has been prepared solely for informational purposes only and is not an offer to buy or sell or a solicitation of any offer to buy or sell any security or other financial instrument, or to participate in any trading strategy.

The Portfolio Management Program was established in 1979 to provide individual investors with a level of personalized portfolio management typically reserved for major institutional investors. All portfolios are managed individually on a fully discretionary basis by Financial Advisors at Morgan Stanley who have been qualified by the firm to independently manage client assets based on training, experience and commitment to service. As your Portfolio Manager, we can offer: 1) direct access to the investment professionals managing your portfolio, 2) personalized service, 3) a disciplined, multipart investment process, 4) ongoing client communications and reporting, and 5) access to the intellectual capital and global resources of Morgan Stanley.

The individuals mentioned as the Portfolio Management Team are Financial Advisors with Morgan Stanley Smith Barney participating in the Morgan Stanley Smith Barney Portfolio Management program. The Portfolio Management program is an investment advisory program in which the client's Financial Advisor invests the client's assets on a discretionary basis in a range of securities. The Portfolio Management program is described in the applicable Morgan Stanley Smith Barney ADV Part 2, available at www.morganstanley.com/wealth-investmentsolutions/advbrochures.html or from your Financial Advisor.

The MSCI All Country World Index (ACWI) is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global developed and emerging markets. An investment cannot be made directly in a market index. The Barclays Capital U.S. Aggregate Bond index measures the performance of the U.S. investment grade bond market. An investment cannot be made directly in a market index.

Risks: All investing involves risk, including the potential for the loss of capital. There is no guarantee that investors will reach their investment specific goals. There is no guarantee that returns will be available in a timeframe meaningful to the investor, and the specific portfolios do not guarantee a gain or guarantee against a loss. This investment strategy may underperform a buy-and-hold strategy. Excess returns may be negative and may detract from performance. Every portfolio has its own unique risks.

Technical analysis is the study of past price and volume trends of a security in an attempt to predict the security's future price and volume trends. Its limitations include but are not limited to: the lack of fundamental analysis of a security's financial condition, lack of analysis of macro-economic trend forecasts, the bias of the technician's view and that possibility that past participants were not entirely rational in their past purchases or sales of the security being analyzed. Investors using technical analysis should consider these limitations prior to making an investment decision.

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