El Menudo Cuenta®

Investment Management Whitepaper



Overview

Asset allocation is the single largest determinant of portfolio variability, so it is the most important decision investors make.1 Yet, for reasons well-visited in the Behavioral Finance literature,2 it is the one decision that individual investors are most likely to get wrong. The greatest value that EMC provides its clients is considered, deliberate asset allocation that matches portfolio risk to the client's ability and willingness to bear risk, and efficiently harnesses the factors of return.

Secondly, individual investors face challenging biases that prevent them from adequately saving to fund their financial goals. EMC helps individual investors meet their financial goals by ensuring that they remain planful in their investing approach through automatic plan contributions, contingent and calendar-based rebalancing, and other tools to ensure time-consistency.

Rationale

It is well known that it is very difficult to beat the market over long periods of time. For example, Michael Mauboussin estimates the likelihood of beating the S&P 500 15 years in a row to be one in 2.3 million.3 The law of large numbers suggests that the wisdom of crowds should provide more accurate estimates of value than individual market participants. It is therefore generally true that financial markets efficiently price publicly traded securities, assigning higher prices to more valuable securities, and lower prices to less valuable ones. For this reason, holding the market portfolio is a rational investment response to a rationally priced market.

While it is true that the intelligent investor can enjoy an analytical, informational, or behavioral edge that allows them to value an individual or a set of securities more accurately on a consistent basis4, such an edge is difficult to scale and apply broadly to create an edge while at the same time maintaining a portfolio diversified with respect to asset class, geography, stage of development, and liquidity. The demands of rigor and comprehensiveness are exceedingly difficult to satisfy in this case, and these demands must be satisfied to justify the assumption of idiosyncratic, potentially uncompensated or

undercompensated risk.

Therefore,the diversified, multi-asset class investor starts with the market portfolio. Still, passive investment is not a panacea; the risk and return of the market portfolio result from taking the average of all risks and returns in the market, and these simply aren't appropriate for every investor. The market portfolio is the portfolio of the average investor, and not all investors are average. Furthermore, the relative balance of asset classes in the market portfolio changes along with changes in the rates of economic growth, inflation, interest, and stability. To maintain consistent risk targets, the market portfolio holder must rebalance, introducing issues of concentration and timing. Lastly, investors typically contribute and withdraw from their investments as their liquidity requirements dictate; even long-term investors face short-term investment decisions.

Additionally, the occasional emergence of speculative bubbles provides an existence proof that, although the market may generally provide accurate estimates of the value of investments, it is nonetheless prone to fits of irrationality.5 When these episodes resolve, they are not only associated with heightened volatility6, but can often result in prolonged periods of lackluster or even negative returns.7

For these reasons,the buy-and-hold strategy is not optimal; instead, long-term investors are better served by employing a dynamic asset allocation, as these are shown to outperform buy-and-hold strategies over time.8 Accordingly, El Menudo Cuenta provides its clients with portfolios that are comprised of passive investment instruments with asset weightings that dynamically adjust to changes in the relative weights of the global market portfolio. These tilts allow the investor to harvest diversification return9 or volatility pumping10 while maintaining their target risk exposures.

Portfolio Construction

EMC designs portfolios that are based in the global market portfolio, but whose weightings are tilted to accommodate different investor risk profiles as well as EMC’s asset class forecasts. Whereas traditionally investment portfolios have been constructed primarily of equity, fixed income, and cash, we have witnessed recently that in periods of low growth and high inflation the standard Balanced Portfolio dramatically underperforms. In order to

provide growth- and inflation-regime independent risk reduction, portfolios must necessarily include significant allocations to long volatility and real assets. EMC's portfolios, therefore, and in departure from established practice, include allocations to such asset classes.

Portfolios

These portfolios are as follows:

Portfolio 1: An aggressive, growth-oriented investment portfolio, it is equity-centric and focuses on long-term appreciation of capital. It is benchmarked [90%] against the [S&P 500], [5%] against the [Bloomberg US Agg], and [5%] against the [HFR Index], and is permitted 3% of tracking error.

Portfolio 2: Balanced, Growth/Income Portfolio: While maintaining a high degree of equity-centricity, it nonetheless has a higher allocation to safe and alternative investments to reduce volatility and equity market beta. It is benchmarked [50%] against the [S&P 500], [35%] against the [Bloomberg US Agg], and [15%] against the [HFR Index], and is permitted 3% of tracking error.

Portfolio 3: Conservative, Income Portfolio: Like the Balanced Portfolio, it maintains a high degree of equity-centricity, and features higher allocations to safe and alternative investments to reduce volatility and equity market beta. In addition, the portfolio's tilts are more exaggerated than the Balanced Portfolio, as it will more readily oscillate between risky and safe positions based on EMC's expectation for heightened market risk. It is benchmarked [45%] against the [S&P 500], [35%] against the [Bloomberg US Agg], and [20%] against the [HFR Index], and is permitted 2% of tracking error.

Portfolio 4: The Enhanced Yield, Income/Capital Preservation Portfolio, unlike Portfolios 1 – 3, is not equity-centric, and instead delivers its expected return through allocations to a variety of fixed-income instruments, fixed-income proxies, and investments that Investment Philosophy demonstrate counter-cyclicality. It is benchmarked [100%] against the [Bloomberg US Agg], and is permitted 2% of tracking error.

Portfolio 5: The Purchasing Power Preserve, Capital Preservation Portfolio, is our most conservative portfolio, and is managed to produce returns in excess of inflation. It is benchmarked [100%] against the [90 Day US T-Bill Rate], and is permitted 1% of tracking error.

Portfolio Management

The Strategic Asset Allocation (SAA) is set on a quarterly basis by an investment committee. The Commitee reviews recent performance, assesses capital market expectations, and formulates the Policy Portfolio on which all EMC portfolios are based. Investment professionals then produce target allocations for each risk level using standard portfolio optimization techniques. The resulting portfolio changes are then implemented as of the next most recent rebalancing period.

While SAA takes place on a quarterly basis, and is focused on long-term allocations, Tactical Asset Allocation occurs on a contingent basis, based on market activity or as other circumstances require. Abrupt changes in market expectations sometimes call for inter-calendrical portfolio adjustments, and these are implemented as necessary to manage risk or seize intermediate opportunities. Assets are invested as they are received independent of the rebalancing processes described above.

Executionsare performed on a block basis, with executions allocated to portfolios on a pro-rata basis. Blocks are executed on a volume-weighted average price (VWAP) basis so as to obtain average execution and to avoid favor or disfavor to investors based on when their contributions are received, and to avoid timing effects.

References

1 Brinson, Hood, Beebower (1986); Brinson, Hood, Singer (1991)

2 Beginning most notably with Kahneman, Tversky (1979)

3 More Than You Know: Finding Financial Wisdom in Unconventional Places, New York Columbia University, pp. 44-45.

4 Buffet, Warren (1984). “The Superinvestors of Grahma-and-Doddsville”. Hermes: The Columbia Business School Magazine: 4-15.

5 A commonplace notably advanced in Charles Mackay’s Memoirs of Extraordinary Popular Delusions and the Madness of Crowds (1869), more recently in J.K. Galbraith’s A Short History of Financial Euphoria (1993), and Charles P. Kindleberger and Robert Aliber’s Manias, Panics, and Crashes: A History of Financial Crises (2005).

6 Rudiger Dornbusch (1976). “Expectations and Exchange Rate Dynamics”. Journal of Political Economy. 84 (6): 1161–1176.

7 Milton Friedman and Anna Schwartz (1971), A Monetary History of the United States, 1867–1960. Princeton University Press

8 Paul Samuelson (1969); Robert Merton (1969, 1971); William F. Sharpe and Andre Perold (1988); and William F. Sharpe (2009).

9 Booth and Fama (1992).

10 Luenberger (1997).

Investment products | Not FDIC insured | No bank guarantee | May lose value

Important Disclosures

Investing involves risk, including loss of principal. Please consider, among other important factors, your investment objectives, risk tolerance and El Menudo Cuenta's pricing before investing. Investment advisory services offered by El Menudo Cuenta, LLC (EMC), an SEC-registered investment advisor. Brokerage services are provided to clients of EMC by Interactive Brokers, LLC., an SEC-registered broker-dealer and member FINRA/SIPC.

1. A properly suggested portfolio recommendation is dependent upon current and accurate financial and risk profiles. Clients who have experienced changes to their goals, financial circumstances, or investment objectives, or who wish to modify their portfolio recommendation, should promptly update their information in the EMC app.

2. EMC Subscription Fees are assessed based on the tier of services in which you are enrolled. EMC does not charge transactional fees, commissions or fees based on assets.

3. The ETFs comprising the portfolios charge fees and expenses that will reduce a client's return. Investors should consider the investment objectives, risks, charges and expenses of the funds carefully before investing. Investment policies, management fees and other information can be found in the individual ETF's prospectus. Please read each prospectus carefully before investing.

4. Inversiones, an individual investment account which invests in a portfolio of ETFs (exchange traded funds), is recommended to clients based on their investment objectives, time horizon, and risk tolerance.

5. For Individual Retirement Account (either Traditional, or ROTH IRA), please consult your tax advisor with any questions.

6. It is not possible to invest directly in an index. Past performance is no guarantee of future results.

7. EMC reserves the right to restrict or revoke any and all offers at any time.

8. Compounding is the process in which an asset's earning from either capital gains or interest are reinvested to generate additional earnings over time. It does not ensure positive performance, nor does it protect against loss. EMC clients may not experience compound returns and investment results will vary based on market volatility and fluctuating prices.

9. Diversification and asset allocation do not guarantee a profit, nor do they eliminate the risk of loss of principal.

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