

## Investment Theme:

### The Quest for Income and Growth (QIG) – Part 1 – The Supplemental Income Portfolio (SIP)

Also featured in *New Jersey Business* magazine, January 2011.

In November's Wealth Management Monitor, we highlighted two acronyms, QE2 (Quantitative Easing 2) and ERP (Equity Risk Premium). Not to be outdone this month, we are introducing QIG (Quest for Income and Growth) and SIP (Supplemental Income Portfolio).

During the second half of this year, we increasingly received client requests to provide higher income in this low interest rate environment. Given our expectation several months ago that the Federal Reserve would keep short-term interest rates (Fed funds) near zero throughout 2011 and into 2012, we took the income challenge seriously and aggressively sought high-yielding exchange-traded funds (ETFs) that met our investment criteria and discipline. This quest led us to asset classes such as preferred equity (ticker PFF), master limited partnerships (AMJ), emerging market sovereign debt (PCY) and short-term credit (CSJ). We are currently researching stocks with high, sustainable dividend yields. This endeavor will be the subject of QIG, Part 2, in January. For now, let's explore the concepts of supplemental income and the Supplemental Income Portfolio.

Supplemental income is a critical concept as it's increasingly required to meet cash flow needs. Making ends meet is especially challenging in an era of slow economic growth, high unemployment, reduced credit availability, and depressed housing prices. The situation is often compounded by regular expenses, like mortgage payments, health care costs or college tuition.

When faced with a widening gap between income and expense, it makes sense to adapt more prudent fiscal measures and invest more wisely. The latter is where a Supplemental Income Portfolio can play a role. Let's first determine what a SIP is not. The investment focus is not solely on yield. While high-yielding securities are part of the process, the investment objective is total return, which encompasses both yield and capital appreciation. In essence, both income and growth are important. Consequently, a SIP is designed to strike an ideal balance of income for cash flow needs and growth for long-term protection.

Income derived from the portfolio can be used to gauge the extent to which cash flow needs are supplemented by investments. This presumes the investor estimated the more critical cash flow requirements. The estimate can therefore influence the cash flow-driven



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portion of the portfolio. It can help dictate the balance between income and growth components. Growth is an important aspect to ensure individuals don't outlive their assets.

A second key feature of SIP is risk control. By way of example, investors who may have been overexposed to the financial sector or a particular financial stock (think Lehman) prior to the financial crisis, have learned the definition of risk the hard way.

Risk is controlled through an asset allocation strategy that utilizes several asset classes. Diversification is achieved by employing asset classes that are, to the extent possible, non-correlating. For instance, the income allocation might include the aforementioned high-yielding asset classes such as preferred equity (7.7% yield), master limited partnerships (5.1% yield) and emerging market sovereign debt (5.8% yield). The growth allocation could include such asset classes as high dividend stocks, emerging market equities and commodities. These riskier assets are the drivers of long-term portfolio performance.

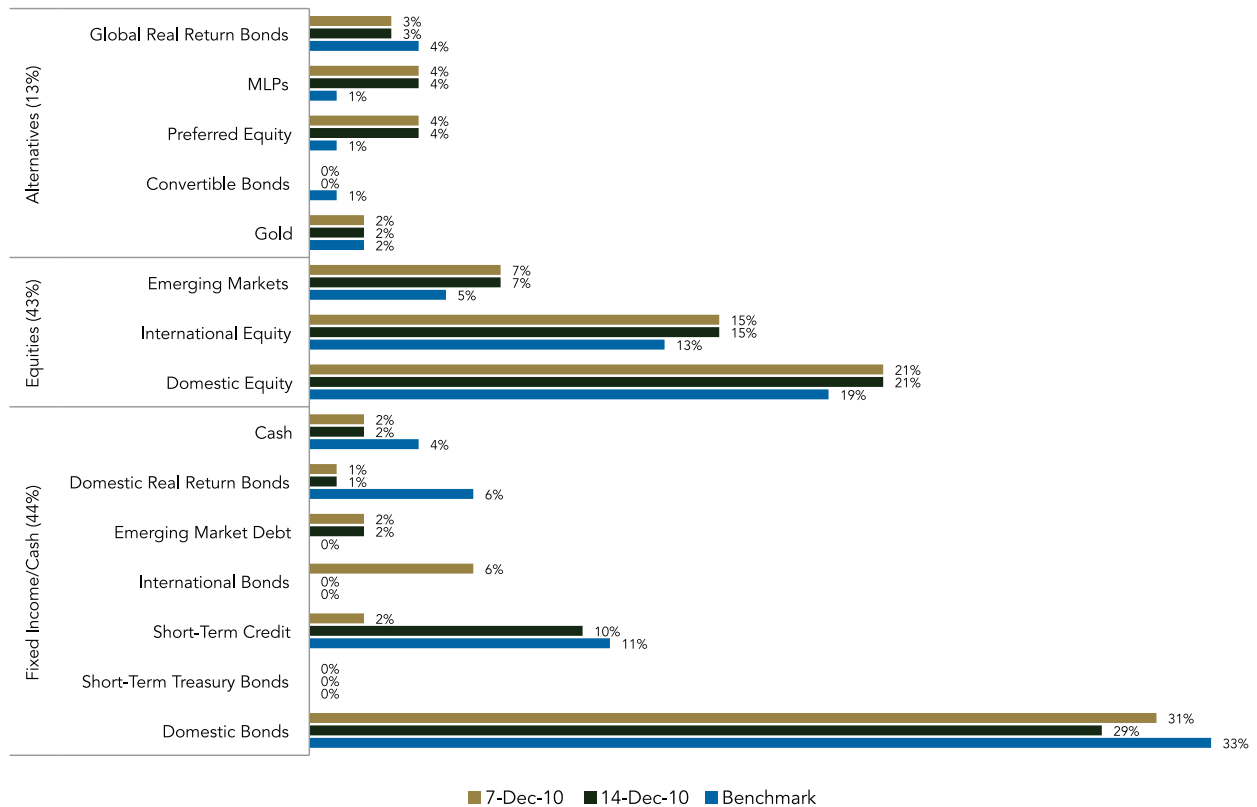
Studies have shown that asset allocation is the key determinant of a portfolio's long-term rate of return with much greater relevance than either individual security selection or market timing. A globally diversified portfolio is enhanced further by utilizing ETFs which are cost-effective. Over time, a passive asset allocation strategy that utilizes ETFs will outperform a 50 percent S&P 500 Index/50 percent Barclays Aggregate Bond benchmark.

Approaching a portfolio with an asset allocation strategy aimed at limiting risk and creating supplemental income is the safest way to cover cash flow needs and establish growth for the future.

## ASSET ALLOCATION RECOMMENDATION

Since mid-November, we have further increased the model's equity exposure and reduced bond weightings based on relative return expectations. International equities, which were a neutral weight, are now 2% overweight. Domestic bonds were taken from neutral to a 4% underweight. We eliminated the international bond position due to extreme illiquidity in the ISHG ETF. Assets have been re-deployed in short-term credit which is now a 10% position. The increased short-term credit exposure combined with underweight positions in domestic and real return bonds significantly reduces duration of the bond component. We remain overweight domestic and emerging market equities and select alternative assets.

Provident **Balanced** Strategy  
Previous/Current Allocation vs. Benchmark Allocation (December 14, 2010)



## MARKET CLOSES

S&P 500 Index: 1,254.60

Dow Jones Industrial Average: 11,533.2

10-Year Treasury Yield: 3.30%



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