



*Globally-Diversified Investment Portfolios - Active Risk Management*

## Fourth Quarter 2011

2011 was dominated by one overriding situation - The European Sovereign Debt Crisis.

The implications of this issue and how it is resolved are of great concern to us as we assess the potential level of risk in the financial markets and in turn how we are structuring our investment portfolios.

When the European Union was formed in 1958, and the common Euro currency adopted in 1999, the members of this economic union did not envision a scenario such as what has unfolded over the last several years. They face two particular broad issues. The first is how they are going to "share" the financial burden that the over-indebted, profligate countries are placing on the EU. There is currently no clear path to doing this and the strong countries (Germany) are reluctant to bail out the weak (virtually everyone else). An inability to resolve this debt crisis could ultimately lead to a dramatic restructuring of the EU. Worst case scenario is dissolution of the EU and the Euro (that would really not be good).

The second broad issue is the great likelihood of a protracted recession within the EU. Greece is already in a depression, and the declines in the much larger economies of Italy, Spain, and France - driven in great part by newly imposed government austerity programs - are beginning to put a drag on economies that have already been struggling to recover from the 2008-2010 global recession. And yes, this will affect the U.S. economy.

While the probabilities of a disastrous outcome are hopefully low, the European situation demands our close attention. *Sometimes, it is not so much a matter of assessing the probability of a certain outcome occurring, but rather the potential consequences should that outcome occur.*

## Why Conventional Asset Allocation Often Fails – Just When You Need It Most!

We have written before about [Asset Allocation and Asset Correlations](#) (that is, how certain asset classes change in value relative to one another). What we have not discussed is this: The methods many investment professionals use to approach conventional asset allocation may not represent the most optimal approach.

Recall that the conventional approach to asset allocation is to invest in a number of different asset classes, hoping that when one zigs the other will zag. Over time, the hope is that one

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will gain in value when the other is in decline, and while an investor may give up some potential gains in strong markets, they may fare better in down markets.

While this theory seems plausible, and while it works some of the time, there have been times, like 2008, *just when it was needed most*, that it did not work very well at all.

We take a different approach to asset allocation. We believe that, instead of selecting asset classes for diversification based on historical correlations of price movements alone, the more optimal approach is to combine asset classes based on economic cycles.

## Changing Seasons of the Economy



BCM's asset allocation decisions are based upon the recognition of changing economic cycles. Economies alternate between growth and recession, inflation and deflation, and each of these economic climates affects various asset classes differently.

- 1) During periods of economic growth, Stocks outperform.**
- 2) During periods of economic recession, Bonds outperform.**
- 3) During periods of rising inflation, Hard Assets (Gold or Commodities) outperform.**
- 4) During periods of deflation, Cash outperforms.**

This perspective differs from conventional asset allocation.

The conventional perspective might say - Bonds rise in value BECAUSE stocks are declining – or vice versa. Our perspective is that Bonds perform well in a slowing economy and the accompanying disinflationary forces make them a good investment – just as a slowing economy makes stocks a potentially poor investment.

The conventional perspective might say - Stocks increase BECAUSE Gold decreases – or vice versa. Our perspective is that Stocks perform well when the economy is growing, and Gold tends to decline in value when there is a strengthening of the dollar.

The assets in our portfolios have been chosen based on how they might best respond to different cycles of the economy, keeping in mind that our allocation to stocks is subject to the outlook of our BCM Market Risk Model. No matter where we find ourselves in the economic cycle, it is likely that one or more of those asset classes will be performing well.

Furthermore, with an informed opinion as to where the economy is headed, it is possible to periodically adjust our allocations in attempt to optimize risk-adjusted returns.

## Current Allocation and Market Outlook

Our *Market Risk Model* continues to suggest caution, particularly with regards to an exposure to stocks. Our portfolios are allocated accordingly. Our core positions in long and short-term bonds and notes, as well as our holding in gold (around which we rebalance as needed) remain in place.

Our outlook is that Europe's problems will likely come to a head and resolution - one way or another - at some point in the next year or so. The financial limbo which is holding the world's financial markets hostage at this moment will not last forever. We are watching and waiting.

As always, thank you so much for your continued trust and confidence.

**Housekeeping** - As we do every year at this time, BCM has recently updated SEC form ADV Part II. Let us know if you would like a current copy of this document for your files. Also enclosed with this report is a copy of our Privacy Statement.

Finally, our accounts are held at the Charles Schwab & Company brokerage firm. Schwab is required and does send a monthly account statement to each of us. If for any reason you are not receiving your monthly account statements (e.g. change of address, etc.), please let us know so that we can remedy that.

Also, please let us know if any personal circumstances have changed that might necessitate a change in your investment strategy, or if you have any specific questions about how your account is managed.

**Tax Info** - As you know, every year Schwab mails to you (usually in February) a form 1099, which contains information necessary for your tax filings.

In addition to form 1099, Schwab also mails out a "Gain/Loss" report (usually in January) for realized capital gains. This report has the cost basis information that your tax preparer needs in order to complete your tax filing. **Please remember to give both the form 1099 and the Gain/Loss report that you receive from Schwab to your tax preparer.**

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