THE DIVERSIFICATION PROCESS

The Benefits of Diversification. At Frontier we believe that diversification can help improve portfolio returns as well as limit declines in portfolio value. For this reason we design an asset allocation strategy for each portfolio we manage.

An asset allocation strategy is a plan for how the assets in a portfolio will be divided among various “asset classes.” Asset classes are types or categories of investments that have similar performance characteristics. Examples include “large company US stocks,” “small company international stocks” and “high quality US bonds.”

Although the individual securities in an asset class may perform differently on a day-to-day basis, they tend to share common performance characteristics over time. While certain asset classes may perform well in one market environment, others may lag. When market conditions change, those that lagged may perform better than yesterday’s top performers. By properly diversifying each portfolio across different asset classes, we can take advantage of their differing performance characteristics. The right combination can improve return while reducing risk.

In building portfolios we use the following 5 major asset class groups and 16 sub-asset classes:

**US Equity**
- US Large Stocks
- US Small Stocks

**Real Assets**
- TIPS
- REITS
- Commodities

**Fixed Income**
- T-Bills
- Int’l Bonds
- High Yield Bonds
- High Quality US Bonds
- Long-Term Gov’t Bonds
- Floating Rate Securities

**Alternatives**
- Absolute Return
- Managed Futures

**Int’l Equity**
- Emerging Markets
- Int’l Small Stocks
- Int’l Large Stocks

These asset classes give us broad exposure to the total investment universe and allow us to build highly diversified portfolios for our clients. By creating portfolios using actively managed mutual funds we gain exposure to even more sub-asset classes such as mid-cap US stocks and the growth and value components of all equity asset classes. We are always looking for new asset classes that further expand our ability to improve portfolio return and control risk.
**Developing the Strategy.** In developing an asset allocation strategy the first step is to establish the long-term return objective and limits on risk for the portfolio. Then we create what we call our “Long-Term Allocation”—it is designed to be the best long-term mix of asset classes to accomplish the return objectives of the portfolio within the established limits on risk.

![Pie chart showing asset allocation](image)

**Long-Term Allocation—Balanced Portfolio**

- US Large Stock
- US Small Stock
- International Large Stock
- Emerging Markets Stock
- Real Estate
- Commodities
- Absolute Return
- US High Quality Bonds

Every month we review the asset allocation strategy for each portfolio to see if modifications are advisable based on changes in the investment environment. An asset allocation strategy that works well in one environment may not work well in another environment.

We review our asset allocation strategies using quantitative models we have developed for each of the 16 sub-asset classes we use in our portfolios. The output from these models provides us with information about the expected future return and risk characteristics of each asset class. It also tells us how each asset class is likely to perform in relation to other asset classes going forward.

Each model is different and each considers a different set of variables. However, they all have one thing in common. They are all based on factors we can measure today. We do not speculate about the future or impose our opinions about the world on our investment process.

Based on the output from our models we increase exposure to asset classes we believe have the best return potential and reduce exposure to those that we believe have less return potential. We limit exposure to asset classes that appear riskier while emphasizing those that appear less risky. We combine the asset classes so that declines in one may be offset by gains in another asset class.
The result is what we call our “Current Allocation.”

![Current Allocation – Balanced Portfolio](image)

We repeat the process every month to see if modifications to the Current Allocation are advisable. Some months we make no adjustments at all. In others the investment environment has changed sufficiently to justify modifications to our asset allocation strategies.

For each portfolio we manage we establish acceptable ranges for each major asset class group.

![Asset Allocation Ranges](image)

We monitor each account on a daily basis to make sure it remains within those limits. An account may drift outside of established ranges for many reasons, including market movements or contributions to the account. If that happens, we bring it back within the acceptable range.

Our approach to portfolio diversification is a disciplined, repeatable process based on over 25 years of experience. We are confident in our process and are proud of the benefits it has produced for our clients over the years. Yet we continue to seek ways to improve it to keep up with changes in the investment environment and the world around us.