Section: Ask S&B
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Title: Core Satellite

Dear S&B: I have heard the term, "core satellite" in your writings as well as other investment publications. What does that mean?

Charles
Santa Barbara

"Core Satellite" investment philosophy refers to portfolio construction typically using a combination of active and passive investments. Several weeks ago we wrote an article on the topic of Active and Passive investments - "passive" would be represented by index replicating investments (ie. S&P500) and "active" would be investments where the skill of a manager would be making the tactical decisions. The foundation of the "core satellite" philosophy is largely built upon the basic concept of asset allocation and global diversification. In the simplest of terms, the theory is to provide a broad exposure to stocks, bonds, cash, and other asset classes so that the anticipated portfolio risk/return characteristics can be maximized. It's like mixing cake batter…you use a combination of ingredients to provide a desire result (ie. a tall cake, short cake, etc.). However, if you put in too much sugar, not enough salt or mess with the flour and yeast proportions, you are far less likely to end up with what you originally intended (which can be a fantastic surprise or a miserable failure).

At the focal point of the "Core and Satellite" philosophy is how the portfolio is constructed (see Core Satellite Exhibit). With ten of thousands of investment choices, and literally dozens of asset classes to choose from – the "Core" is typically made up of what are believed to be the most "efficient" asset classes. So what is meant by "efficient?" Well, those are areas of the investment market where it is believed that information is so widely available that hardly anyone has an opportunity to excel at picking just the "best" options (these are typically the "largest" investments and markets – for example, its very difficult for someone to figure out that General Electric is up to some big "surprise" or that their stock price is heavily undervalued because the market has not figured out their product potential). This is the underlying argument for the use of "passive / index" investing for the broad major markets. It is largely believed that the "core" should be comprised of asset classes such as domestic large cap stocks, domestic mid cap stocks, international developed stocks, and broad fixed income.

"Satellite" investments are commonly identified as high yield bonds, private equity, hedge funds, commodities, small cap, real estate and emerging markets (to name a few). These asset classes tend to provide excellent diversification benefits and are seen to be less informationally efficient

– ie. there is more investment specific information here that is not common knowledge. Thus, it is believed that manager expertise can be essential in these asset classes to obtain the best performance numbers.

Risk Management: The core and satellite approach has been derived from the philosophy that if you diversify properly, you can earn the best returns for the given level of risk you assumed. It does not guarantee success nor that you won't lose money. It also does not guarantee the best results. It just means that you have theoretically maximized your potential for the risk taken. And in the investment world, that is a very good thing.

Tax Management: The "passive / index" component of the core and satellite approach is thought to be one of the most tax-oriented approaches to investing. Though also not guaranteed, index investing has historically spun off far less capital gains than its actively managed mutual fund counterparts.

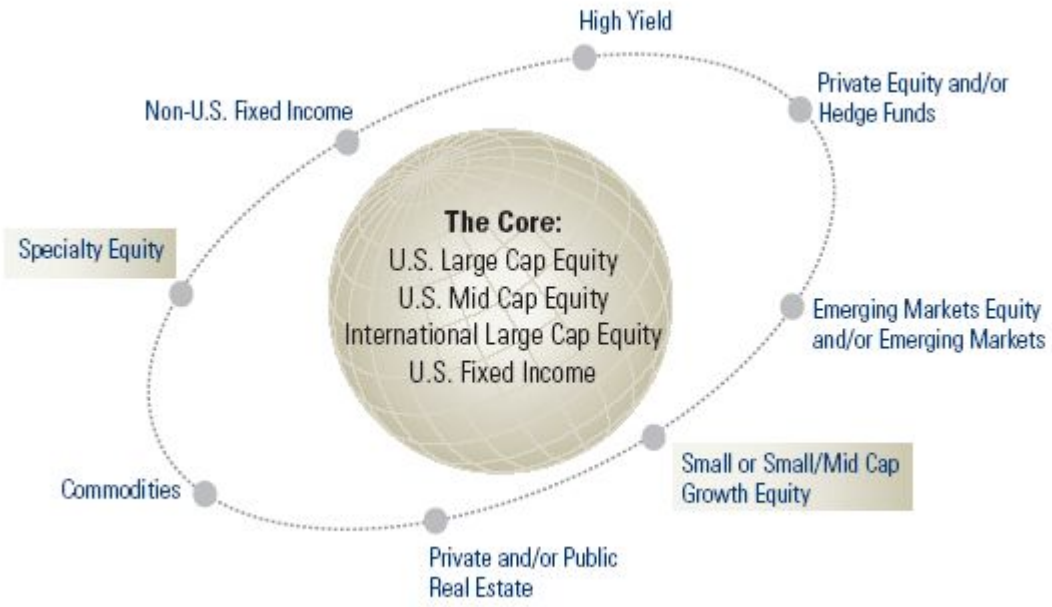
Investment Management: It is not necessary to build every account with this philosophy nor have them mirror one another. When building portfolios, it is often best to come up with a "total" portfolio and then put the different pieces in the appropriate "buckets." For example, one of the satellite investments is "hedge funds," an asset class that is notoriously tax unfriendly. So if you wanted this asset class and you had the choice of investing in it with taxable money or using tax deferred funds (such as your IRA), it may make more sense to own it in an account which avoids immediate taxation.

Sincerely,
Brad and Seth

If you would like to have your specific question answered, please submit your inquiries to:

asksb@missionwealth.com.

Core Satellite Exhibit



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