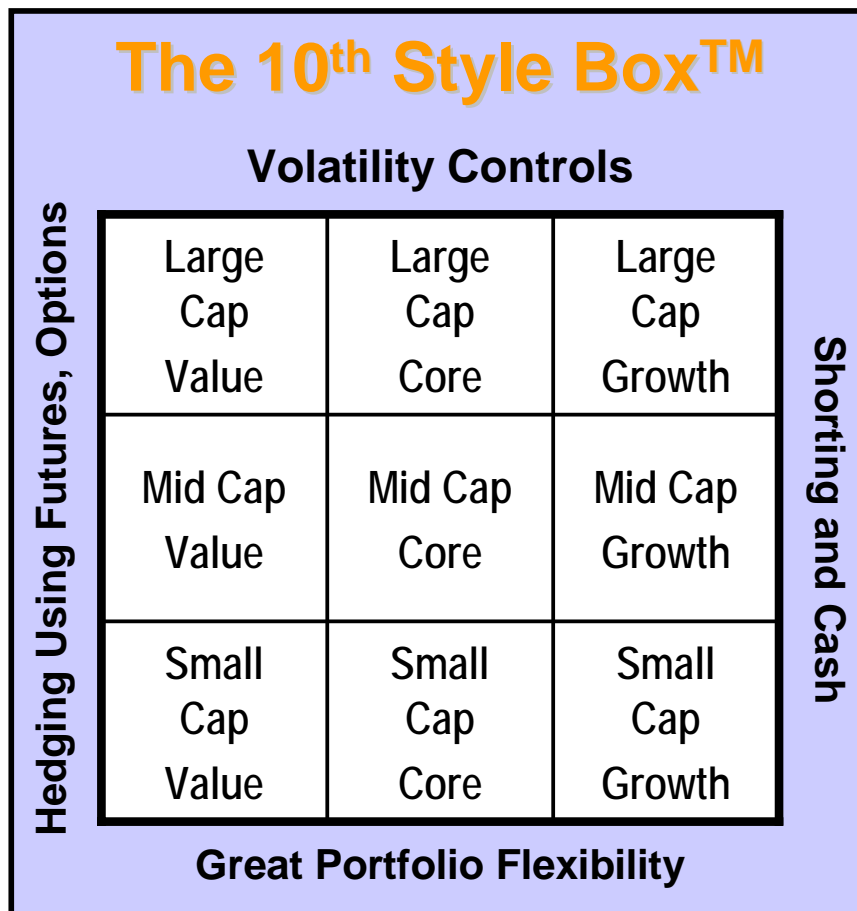


# Enhanced Portfolio Management Utilizing the 10<sup>th</sup> Style Box™



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# Enhanced Portfolio Management Utilizing the 10<sup>th</sup> Style Box™

*A White Paper Presentation by  
Rhoads Lucca Capital Management, Inc.*

The Morningstar Style Box™ was introduced in 1992 as a means of classifying the investment styles of mutual funds to help investors and investment advisers understand what they were investing in and thus diversify more effectively. Over the past 15 years, the style box has become a widely used tool in the asset allocation process. But as an investment tool, it has distinct flaws. These liabilities have given rise to a new investment structure by Rhoads Lucca Capital Management, Inc. -- the **10<sup>th</sup> Style Box™**.

## **Style Box Basics**

The equity Morningstar Style Box™ consists of three composite styles (value, core and growth) and three capitalization categories (large, mid and small-cap). Styles and capitalization classes are determined using a 10-factor method of classifying the individual stocks that make up the fund's portfolio. Based on this assessment of the growth, value and capitalization characteristics of the portfolio, a fund is placed in one of the nine boxes.

The position of a fund within a style box is a snapshot of a specific point in time. Morningstar also classifies funds by "category" based on a three-year composite of the funds' style boxes. As a result, a fund could move from mid-cap value to small-cap growth and back to mid-cap core the third year and be categorized as a mid-cap core fund.

**Morningstar Style Box**

<b>Large Cap Value</b>	<b>Large Cap Core</b>	<b>Large Cap Growth</b>
<b>Mid Cap Value</b>	<b>Mid Cap Core</b>	<b>Mid Cap Growth</b>
<b>Small Cap Value</b>	<b>Small Cap Core</b>	<b>Small Cap Growth</b>

From these style boxes, Morningstar has developed 16 indexes that serve as benchmarks to measure and monitor manager performance. In addition to the nine sub categories, these indexes include a broad market index; value core and growth indexes irrespective of the market capitalization, and large, mid and small-cap market indexes.

Morningstar also provides bond, international (foreign stock) and hybrid style boxes. For the purpose of this paper, just the domestic equity styles are addressed.

### **Style Box Investment Applications**

Under the premise that diversification reduces risk, some investment professionals recommend that investors purchase a fund for each of the nine style box categories. Others recommend a single mid-cap blend fund, aiming for the middle ground. Another investment approach is going for the corners, to make certain the portfolio is well diversified. By tracking the style box positions of the funds within a portfolio, the investor adjusts fund holdings as needed to meet a target balance.

Although Morningstar and many financial advisers promote the use of style boxes for fixed asset allocation portfolios, they also have their use among active management approaches. Rotation among styles such as growth and value, or small, mid and large capitalization funds utilizes style box categories to determine if a fund meets the investment criteria for the category the investor believes is currently positioned to outperform the others.

### **Style Box Limitations as an Investment Tool**

Investment strategies built around the use of style boxes to determine the funds held in a portfolio have become a major limitation on the ability of mutual fund managers to adapt to market conditions. Moving outside of a style category can result in large scale redemptions as investors and investment advisors rebalance to maintain their desired diversification.

Thus in many ways, style boxes have become strait jackets for the funds themselves, limiting the manager's innovation and the ability to adapt to changing market trends.

Another limitation is the perception of diversification as a risk management tool. Many investors mistakenly have the impression that the mutual fund manager will actively modify a fund's portfolio to limit losses in market downturns. In many cases, the fund directives require managers to be, if not fully invested, heavily invested in the asset classes that determine the fund's investment objective, style and category. With asset allocations based on exposure to specific asset classes and management styles, the fund manager's job is to provide that exposure, not to limit risk. In fact, under the style box regime, success is more a matter of meeting or exceeding style benchmarks than producing positive returns.

In market downturns, neither style nor size shelters investors. The Morningstar US Market Index, made up of the nine style boxes, fell -7.02% in 2000, -11.9% in 2001 and -22.2% in 2002 (when all nine style boxes were negative) for a compounded loss of 57% in three years. To make up that loss required a gain of 75% just to breakeven. An investor whose portfolio mirrored the Morningstar US Market Index would have been in a loss position from 2000 to 2006, a period of nearly seven years.

## Morningstar Style Boxes™ Six-Year Recap

2002

Large Cap Value	Large Cap Core	Large Cap Growth
-15.1	-23.8	-33.2
Mid Cap Value	Mid Cap Core	Mid Cap Growth
-10.0	-12.4	-32.5
Small Cap Value	Small Cap Core	Small Cap Growth
-8.2	-14.2	-36.9

2003

Large Cap Value	Large Cap Core	Large Cap Growth
26.3	24.7	30.7
Mid Cap Value	Mid Cap Core	Mid Cap Growth
35.9	38.7	40.0
Small Cap Value	Small Cap Core	Small Cap Growth
48.9	42.6	52.7

2004

Large Cap Value	Large Cap Core	Large Cap Growth
14.1	14.0	0.2
Mid Cap Value	Mid Cap Core	Mid Cap Growth
24.3	19.1	15.5
Small Cap Value	Small Cap Core	Small Cap Growth
24.0	23.6	13.5

2005

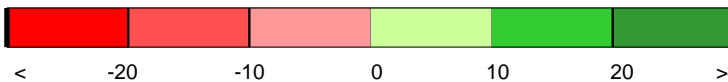
Large Cap Value	Large Cap Core	Large Cap Growth
7.0	3.8	3.4
Mid Cap Value	Mid Cap Core	Mid Cap Growth
11.5	10.1	16.3
Small Cap Value	Small Cap Core	Small Cap Growth
5.1	6.3	5.8

2006

Large Cap Value	Large Cap Core	Large Cap Growth
25.8	15.5	5.7
Mid Cap Value	Mid Cap Core	Mid Cap Growth
18.8	14.7	9.6
Small Cap Value	Small Cap Core	Small Cap Growth
20.0	21.2	10.0

2007

Large Cap Value	Large Cap Core	Large Cap Growth
-0.43	8.64	12.34
Mid Cap Value	Mid Cap Core	Mid Cap Growth
-5.52	1.95	19.70
Small Cap Value	Small Cap Core	Small Cap Growth
-8.15	-5.43	11.08



Source: Morningstar Market Barometer™ Five-Year Recaps, 2002-2006; 2003-2007.

Looking at the style boxes on a periodic table of returns shows both the rotation of performance within the style boxes as well as the potential return investors sacrifice through diversification. In virtually every year, there is at least a 10% return difference between the top performing style box and the Morningstar US Market Index, encompassing all of the boxes.

This is an inherent weakness of fixed asset allocations. In exchange for a potential reduction in volatility, investors must invest in underperforming investment styles as well as top performers. The portfolio is always limited to, at best, average returns.

### Rotation of the Morningstar Style Boxes™

2002	2003	2004	2005	2006	2007
Small Cap Value -8.2	Small Cap Growth 52.7	Mid Cap Value 24.3	Mid Cap Growth 16.3	Large Cap Value 25.8	Mid Cap Growth 19.7
Mid Cap Value -10.0	Small Cap Value 48.9	Small Cap Value 24.0	Mid Cap Value 11.5	Small Cap Core 21.2	Large Cap Growth 12.3
Mid Cap Core -12.4	Small Cap Core 42.6	Small Cap Core 23.6	Mid Cap Core 10.1	Small Cap Value 20.0	Small Cap Growth 11.1
Small Cap Core -14.2	Mid Cap Growth 40.0	Mid Cap Core 19.1	Large Cap Value 7.0	Mid Cap Value 18.8	Large Cap Core 8.6
Large Cap Value -15.1	Mid Cap Core 38.7	Mid Cap Growth 15.5	Small Cap Core 6.3	Large Cap Core 15.5	Mid Cap Core 2.0
Large Cap Core -23.8	Mid Cap Value 35.9	Large Cap Value 14.1	Small Cap Growth 5.8	Mid Cap Core 14.7	Large Cap Value -0.4
Mid Cap Growth -32.5	Large Cap Growth 30.7	Large Cap Core 14.0	Small Cap Value 5.1	Small Cap Growth 10.0	Small Cap Core -5.4
Large Cap Growth -33.2	Large Cap Value 26.3	Small Cap Growth 13.5	Large Cap Core 3.8	Mid Cap Growth 9.6	Mid Cap Value -5.5
Small Cap Growth -36.9	Large Cap Core 24.7	Large Cap Growth 0.2	Large Cap Growth 3.4	Large Cap Growth 5.7	Small Cap Value -8.2
<b>-22.2%</b>	<b>30.7%</b>	<b>12.4%</b>	<b>6.5%</b>	<b>15.7%</b>	<b>5.9%</b>

Data source: Morningstar Market Barometer™ Five-Year Recap, 2002-2006; 2003-2007.

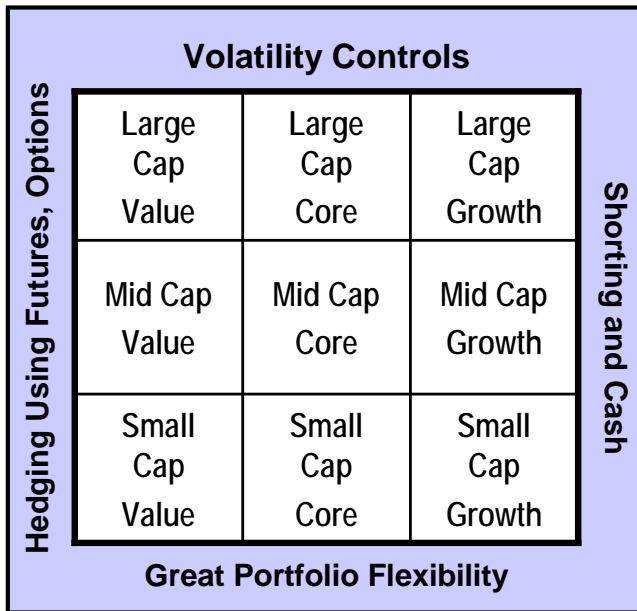
### Beyond the Morningstar Box

*"Wide diversification is only required when investors do not understand what they are doing."*  
Warren Buffett

The 10<sup>th</sup> Style Box™ encompasses the nine normal style boxes, without being restricted to a specific style other than that of opportunity. Its benchmark is to meaningfully outperform buy-and-hold diversified portfolios in uptrends and achieve meaningfully smaller negative returns in downtrends while controlling the volatility of the portfolio at all times.

The 10<sup>th</sup> Style Box™ seeks to eliminate the greatest limitations of the Morningstar style box categories – the inability of fund managers to follow market leadership or manage risk while remaining within their “box.” Like the funds that make up the nine style boxes, the 10<sup>th</sup> Style Box™ invests in individual stocks, with the flexibility to invest in securities issued by non-US companies as well as domestic stocks and bonds.

In its outer perimeter are strategies such as the ability to go to a “cash” position; to concentrate its holdings in a limited number of positions, and to use futures and



*The encompassing 10<sup>th</sup> Style Box™ addresses risk in the portfolio.*

options to hedge either market exposure or particular security exposure, or to control the volatility of the portfolio.

**Applying the 10<sup>th</sup> Style Box™ to the Portfolio**

Application of the 10<sup>th</sup> Style Box™ starts with identifying companies with the characteristics Rhoads Lucca managers believe indicate potential market leaders. The firm runs quantitative screens on a database of around 6,000 stocks. These screens reduce its opportunity list to around 300 companies of which 35 to 200 may be determined suitable for the portfolio. While targeted

companies have the potential to be superstars, there's no way to predict which, if any, will achieve that status. Thus, the need for diversification.

Fundamental valuation analysis is not conducted on an individual security level. Fundamental screens are used, however, on industry and market levels to evaluate the desirability of investing. Diversification in the 10<sup>th</sup> Style Box™ is driven by the market leaders selected; as a result there is no attempt to diversify across industry sectors.

Technical models are used to guide when it is time to buy or sell companies. Among the criteria to add a stock to the 10<sup>th</sup> Style Box™ is upward price movement. Regardless of market cap or the growth or value characteristics of a company, if its stock is not currently showing an upward trend in market value, it will not have a place in the Style Box. Buy and sell decisions are quickly made. Either the company meets the test or it doesn't. The stock price is either performing in an investor friendly way or it isn't.

Thus, the 10<sup>th</sup> Style Box™ encompasses an equity portfolio that is dynamic in nature, not self-limiting at seeking returns, and not constrained to being fully invested or fully diversified at times when few or no stock positions are going up. The ability to move to cash and to use futures and options is essential to driving above market returns with lower volatility than the market.

Volatility is the most difficult factor an active investment strategy such as the 10<sup>th</sup> Style Box™ must overcome. Volatility can result in whipsaw trades when the market reverses direction too quickly for the manager to stay on the right side of the trend, resulting in losing trades. (Portfolios of individual stocks can also incur excessive trading costs in attempts to respond to market volatility.) The 10<sup>th</sup> Style

Box™'s ability to conduct hedging from time to time using futures and/or options provides exceptional tools to manage volatility, which most portfolio managers and mutual funds don't utilize.

Assuming the portfolio manager understands the purpose of options and futures in the portfolio and is experienced in using these tools, they are extremely efficient, cost effective tools to use when managing volatility.

If the 10<sup>th</sup> Style Box™ manager believes the overall market is overvalued and/or technically vulnerable to a decline, or if the adviser cannot find a sufficient number of stocks with near term appreciation potential, the manager has the discretion to move all or a portion of the Fund's assets into fixed-income securities, in order to take a more defensive position. In an application of the Rhoads Lucca 10<sup>th</sup> Style Box™ strategy in 2007, when the S&P 500 corrected 18%, the 10<sup>th</sup> Style Box™ managed portfolio corrected 9%.

This ability to limit draw downs puts the mathematics of gains and losses on the portfolio manager's side. While the S&P 500 will have to gain 22% to recover from an 18% loss, the 10<sup>th</sup> Style Box™ needs to regain just 10% to recover from a 9% loss. That gives the Style Box 12% leverage over buying and holding the S&P 500.

### **In Summary**

While a fixed allocation, diversified portfolio based on the nine original style boxes is typically promoted as an easy way to invest, in reality, it is one of the most difficult and riskiest strategies. A buy-and-hold investor has to be willing and able to accept the risk of holding a portfolio through periods of 50 to 60% declines in the market. History shows that these periods happen far more frequently than statistics might indicate, with the most recent period occurring in 2000-2002. Studies such as the Dalbar QAIB study have consistently shown that the average investor fails to buy and hold through full market cycles.

The 10<sup>th</sup> Style Box™ is designed to overcome the limitations of asset allocation investment strategies based on the original nine style boxes:

- ✦ Morningstar style boxes limit the fund manager's innovation and the ability to adapt to market trends. Funds that shift within the style boxes tend to lose assets due to perceived inconsistency.
- ✦ Fund managers are typically restricted in their ability to modify a fund's portfolio to limit losses in market downturns. In many cases, fund managers are also required to be, if not fully invested, heavily invested in the asset classes that determine the fund's investment objective, style and category regardless of market direction.
- ✦ Diversification has limited value as a risk management tool. In major market downturns, neither style nor size shelters investors from losses.

- ✦ Inherent in the nature of diversified asset allocation are average returns. Stellar returns from one style and / or market capitalization category are muted by the performance of lower return styles and market cap groups.

By incorporating a defensive strategy as well as a strategy for pursuing gains, the 10th Style Box™ seeks to avoid losing substantial portions of gains to market cycles. Consistency of investment returns over a complete cycle of a rising and falling market, capturing and keeping small, incremental gains are sought rather than large gains offset by large losses.

For many investors, the 10<sup>th</sup> Style Box™ strategy allows them to put their investment on "autopilot," investing for the long term and deferring day-to-day investment decisions to the active management of the adviser.

*As with all investment strategies and mutual funds, there is the risk that you could lose money through a 10<sup>th</sup> Style Box™ approach. There can be no assurance the strategy will meet its investment objective. Short selling or investing in options and futures may subject the fund to additional volatility. Investing in mid and small-cap securities have special risks associated including wider variations in earnings and business prospects than larger, more established companies. Investments in the shares of other mutual and exchange traded funds (ETFs) may be subject to the funds' own operating fees and expenses.*

*Rhoads Lucca provides fee-based investment management services for private individuals and institutions across the United States and abroad. Its portfolio managers manage the Autopilot Funds™ ([www.autopilotfunds.com](http://www.autopilotfunds.com)). Founded in 1980, Rhoads Lucca has been a Registered Investment Advisor with the U.S. Securities and Exchange Commission (SEC) since 1986. The firm can be found on the internet at [www.rhoadslucca.com](http://www.rhoadslucca.com).*

*Morningstar Style Boxes™ is a trademark of Morningstar, Inc.*

*The 10<sup>th</sup> Style Box™ is a trademark of Rhoads Lucca Capital Management, Inc.*

*Investors should carefully consider the investment objectives, risks, charges and expenses of the Autopilot Managed Growth Fund™. This and other information about the Autopilot Managed Growth Fund™ is contained in the prospectus, which can be obtained at [www.autopilotfunds.com](http://www.autopilotfunds.com) or by calling 1-866-828-8674 and should be read carefully before investing. The Autopilot Managed Growth Fund™ is distributed by Northern Lights Distributors, LLC, member FINRA/SIPC.*

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