

Strategic Investing



As the chief investment officer for the Personal Financial Services Group, **John Skjervem** leads Northern Trust's national investment management practice and develops the firm's private client services investment policy. Here John shares with *Wealth* his thoughts on market behavior, volatility and portfolio construction.

John earned an M.B.A. degree with concentrations in Finance and Statistics from the University of Chicago's Graduate School of Business, and received his B.A. degree in Economics from the University of California at Santa Barbara. He holds both the Chartered Financial Analyst (CFA) and Certified Trust and Financial Advisor (CTFA) designations, and is a member of the Los Angeles Society of Financial Analysts.

This has been a challenging year for investors in many ways. Do you see anything developing in the markets that may change that?

The first half of 2005 was disappointing for many investors because financial asset returns were essentially flat. However, we think we're going to end the year with positive returns to financial assets — stocks in particular. But our expectations for those returns are mid- to high-single digits.

Why are returns expected to stay in single digits?

The stock market will likely track corporate earnings, which in the United States this year should be up 7% to 8% over 2004 levels. But corporate earnings grew 17% in 2004 and 15% in 2003, so the first half of 2005 was largely an adjustment process from the much stronger double-digit earnings growth in the two preceding years.

The United States is increasingly alone in that we currently enjoy a "Goldilocks" scenario comprised of contained inflation, stable long-term interest rates and continued growth in corporate earnings — even though that earnings growth has now moderated. So this is still very much a good news story.

What do you recommend for people who are looking for returns higher than single digits?

We're cautious about reaching for returns independent of an overall investment strategy. Chasing higher returns, more often than not, will translate into taking additional risk. Instead of chasing short-term performance, we would rather focus on minimizing volatility through strategic asset allocation and diversification. We see this as a more reliable way to maximize long-term return potential.

We do recommend certain high-return asset classes, but only within the context of an overall diversification plan. For example, in our opinion private equity has and will continue to be the financial asset class with the highest compound annual returns. However, due to its illiquidity and other unique investment dynamics, the private equity investment horizon is realistically five to seven or more years. Accordingly, private equity investments should be made in the context of a client's aggregate portfolio and with a long-term time horizon of several years.

The other asset class frequently cited as a source of higher returns is hedge funds. In our portfolio recommendations, hedge funds play a

different role. We include hedge funds exposure to lower a portfolio's volatility profile — both because hedge funds often respond differently than stocks and bonds to economic events and because of the types of hedging strategies they pursue. As such, hedge funds can represent an important part of our risk management strategy.

Can you explain why it's important to manage volatility as a way to improve long-term results?

What really matters is a portfolio's ability to help you achieve your long-term goals. And its terminal value, or the bottom-line three, five, or 10 years from now, is historically more a function of how well you manage volatility than the return profile of any asset class at any point in time. Your portfolio's terminal value is a function of the compound return, which can be influenced significantly by volatility. Our role as portfolio managers — and our broader role as stewards of wealth — is to strive to preserve or maximize terminal value. We believe we can best accomplish this by minimizing volatility.

What strategies do you use to minimize volatility?

Asset allocation — expanding your investments to multiple asset classes — is probably the most consistent, reliable way to minimize volatility. We have to do our homework on each of these asset classes in terms of suitability and attractiveness at any point in time, and also take reasonable steps to increase the likelihood that the vehicle we use to get that asset class exposure — individual securities, an exchange-traded fund (ETF), a mutual fund, a private placement — is effective as well. But ultimately it's the intelligent assembly of a portfolio that includes multiple asset classes that should succeed in compressing volatility.



Does the relatively low value of the U.S. dollar compared to other major currencies make now a particularly good time to invest in non-U.S. equities?

We don't use currency forecasts as the basis of our international investments because they can be unreliable as the basis of a longer-term investment strategy. The currency element is something we take into consideration, but it's not the basis for the recommendation.

We continue to recommend non-U.S. equity investments based first and foremost on the tenet of diversification. Non-U.S. equities provide investment opportunities that historically have appreciated in a different manner and on a different timeline than domestic equities have. And that's the basis of diversification. Of course, at any point in time there may be company- or country-specific opportunities we might want to take advantage of.

More than half of the world's investment opportunities on the equity side are outside of the United States. Having some exposure to these investments is consistent with carrying out our fiduciary responsibilities of putting our clients' interests first. ■

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