

September 2011

Ibbotson Associates Dynamic Allocation Update

Summary

On September 20, 2011, the Investment Policy Committee (“the IPC,” “the Committee”) decided to add the following allocation to our dynamic asset allocation positions:

- Underweight of equities (U.S., other developed market equities, and emerging market equities), and overweight short-term high quality debt (Treasury bills, short-term corporate paper, and other short-term liquid assets generally referred to as “cash” or “cash equivalents”).

In addition, the IPC decided to keep in place the following allocations:

- Overweight of U.S. large-cap equities and underweight of U.S. REITs.
- Overweight of U.S. large-cap equities and underweight of U.S. small-cap equities.
- Overweight of U.S. investment-grade corporate debt and underweight of U.S. high-yield corporate debt.

Background

Macroeconomic data confirm the economic slowdown in the U.S., so in our opinion the odds of a recession have increased. Job market data, consumer confidence indices, and survey data from managers continue to point to a worsening economic climate. The latest press release from the Federal Open Market Committee, together with the resolution of the Federal Reserve to implement further monetary stimulus, reinforces our belief that economic conditions are far from improving and are getting worse.

Moreover, the international economic climate has worsened, with slowdowns in the eurozone and China indicated by their respective Purchasing Managers’ indices for September. The probability of a liquidity and solvency crisis in the eurozone, possibly spreading to the U.S. through the banking sector, is rising as well.

In addition, we think that the policy responses to these unfolding events are tardy, insufficient, and ineffective. Fiscal stimulus necessitates political consensus, or at least compromise, and so far, such compromise is scant, in both sides of the Atlantic. If anything, fiscal policy leans toward short-term austerity, without a long-term commitment to reigning in deficits, which is the worst policy combination that governments could implement in the current economic environment.

Monetary stimulus in the U.S. is hesitant, and likely to be ineffective, since interest rates are already historically low and, at present, are not the binding constraint preventing the economy from growing faster. (We will elaborate on this in the quarterly commentary, to be produced in early October.) In the eurozone, the European Central Bank has agreed to buy sovereign debt of battered countries, such as Italy and Spain, but only in exchange for fiscal austerity.



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Underweight of equities and overweight of cash (Sep. 20, 2011)

We believe that in the event of a recession, a financial crisis, or even in an environment where capital markets perceive that, the likelihood of either event is rising; equities are likely to deliver negative returns.

While it is true that most major equity indices (S&P 500, Euro Stoxx 50, along with national equity indices in Europe, FTSE 100, Topix 100, MSCI EM) have all lost between 10% and 25% since the beginning of 2011, we believe that those losses are actually small relative to the potential for price declines in any of the scenarios described above. In our opinion, the negative events that we fear might occur in the short term are not fully priced in.

Whereas some equity markets appear more susceptible to losses, due to richer valuations, or to a higher sensitivity to global asset price changes, it is likely that, in the scenarios described above, all equity markets would lose value. Moreover, in a scenario of high volatility, flights-to-safety, and financial stress, picking winners and losers becomes extremely difficult, as markets respond more to sentiment than to fundamentals. Finally, the correlation of equity markets across the world has increased over the years, and tends to increase even further during periods of high volatility.

For the reasons described above, the IPC decided to recommend an underweight of all equities in our dynamic portfolios. In deciding where to source this underweight, the Committee considered sovereign debt, due to its place as a less risky asset class in times of high volatility. However, long-term yields are already historically low (the 10-year Treasury yield hit a 40-year low this week), real yields are already well into negative territory, and the potential for further price appreciation of treasuries is very limited. Additionally, in the event that we are proven wrong and neither a recession nor a financial crisis occurs in the short term, the lower duration of short-term debt may help us against the likely rise of yields.

Underweight of U.S. REITs and overweight of U.S. large-cap equities (Jun. 21, 2011)

In spite of the most recent declines in the price of U.S. REITs, we believe that their valuations are still rich relative to most other U.S. equity sectors. Dividend yields, as well as price-to-FFO (flow from operations) are difficult to reconcile with yields and price multiples of U.S. equities as a whole. Moreover, low occupancy rates, moderate growth of rental rates, and struggling commercial real estate prices, lead us to expect an unfavorable risk/return ratio from U.S. REITs.

The IPC believes that such extreme valuation ratios are not likely to persist beyond the next 6 to 18 months. A price correction, we believe, is likely to bring those valuation metrics to values more in line with historical trends, and more in line with the valuation of other risky assets such as U.S. equities, hence the underweight of U.S. REITs.

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In deciding where to source the underweight of U.S. REITs, the IPC gave preference to asset denominated in U.S. dollars, and a more favorable risk/return profile in the medium term than U.S. REITs, while retaining some risk exposure.

The IPC believes that U.S. large-cap equities fit the bill. Although they have enjoyed respectable returns over the last 12 months, the valuation of large-cap equities appear to be less stretched than those of other sub-classes within the equity space (small-cap, growth equities, etc.).

U.S. REITs also appear expensive relative to global ex-U.S. REITs. Most valuation metrics are favorable to the latter. However, relative to their own historical values of valuation metrics, global ex-U.S. REITs are not particularly cheap. For that reason, we are not as confident that international REITs can beat U.S. REITs in the medium term, or at least not by as much as large-cap U.S. equities can.

Overweight of U.S. investment-grade corporate debt and underweight of U.S. high-yield debt (Aug. 24, 2011)

This allocation complements and is motivated by the same reasons as the removal of the overweight of U.S. corporate debt relative to U.S. sovereign debt (discussed in our note from August 26). If a recession (or a debt crisis in the eurozone) occurs, not only can credit spreads widen, but they can widen more for issuers with less credit quality. Lower-rated issuers have a higher risk of default and a more difficult time finding market financing at all during a credit squeeze.

Overweight of U.S. large-cap equities and underweight of U.S. small-cap equities (Aug. 24, 2011)

U.S. small-cap equities outperformed large-cap in the recent past. Those larger appreciations of small-cap equities relative to large-cap equities have stretched their price ratios, and depressed their dividend yields. Whether one looks at price-to-earnings ratios, price-to-sales, price-to-book value, or dividend yields, large-cap stocks as a whole appear cheaper than small-cap stocks. To be clear: neither large-cap nor small-cap U.S. equities look like clear bargains to us. But relatively speaking, large-cap U.S. equities may be priced to deliver better returns than small-cap equities.

The one department where small-caps might look more promising is in margins: net margins for large-cap equities are already above their previous maximum, whereas margins for small-cap are still significantly below their previous maximum. The picture, however, is less favorable to small-cap equities if one looks at operating margins instead. And in any case, higher margins for large-cap equities might be a reflection of business success relative to small-cap equities, rather than a foreboding of declining margins.

In addition to valuation, we need to factor in risk. In a context of heightened volatility and risk aversion, we believe that large-cap equities will perform better than small-cap equities, as investors seek the perceived safety of stronger balance sheets, more diversified businesses, and higher dividend yield.

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Definitions:

Purchasing Managers Index: an indicator of the economic health of the manufacturing sector. The PMI Index is based on five major indicators: new orders, inventory levels, production, supplier deliveries and employment environment.

Topix 100 Index: a capitalization-weighted index of all companies listed on the First Section (the most secure stocks) of the Tokyo Stock Exchange.

Standard & Poor's 500 Index: Market-capitalization-weighted index of 500 widely held stocks. Member companies are chosen based on market size, liquidity, and industry group representation. Included are the stocks of industrial, financial, utility and transportation companies.

The EURO STOXX 50 Index, Europe's leading Blue-chip index for the Eurozone, provides a Blue-chip representation of supersector leaders in the Eurozone. The index covers 50 stocks from 12 Eurozone countries: Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain.

The FTSE 100 Index consists of 100 blue chip stocks that trade on the London Stock Exchange

MSCI Emerging Markets Index: Capitalization-weighted index measuring the total returns of stocks from a number of emerging markets across the world.

One cannot invest directly in an index.

Important Information

The Ibbotson ETF Allocation Series Portfolios are not Exchange Traded Funds (ETFs), instead they consist of five risk-based asset allocation portfolios that invest in underlying ETFs, which are typically open-end investment companies or unit investment trusts.

Shares of the Portfolios are offered only to participating insurance companies and their separate accounts to fund the benefits of Variable Contracts, and to qualified pension and retirement plans and registered and unregistered separate accounts.

ALPS Advisors, Inc. is the investment adviser to the Portfolio and Ibbotson Associates, Inc. is the investment sub-adviser to the Portfolio. ALPS and Ibbotson Associates are unaffiliated entities.

This commentary contains certain forward-looking statements. We use words such as “expects”, “anticipates”, “believes”, “estimates”, “Forecasts”, and similar expressions to identify forward-looking statements. Such forward-looking statements involve known and unknown risks, uncertainties and other factors which may cause the actual results to differ materially and/or substantially from any future results, performance or achievements expressed or implied by those projected in the forward-looking statements for any reason. Past performance does not guarantee future results.

An investor should consider the investment objectives, risks, charges and expenses of the Fund (or of the Investment Company) carefully before investing. To obtain a prospectus containing this and other information, please call 1-866-432-2926. Read the prospectus carefully before you invest.

Investing involves risk including loss of principle.

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About Ibbotson

Ibbotson Associates is a leading independent provider of asset allocation, manager selection, and portfolio construction services. The company leverages its innovative academic research to create customized investment advisory solutions that help investors meet their goals.

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