



Expanding the Efficient Frontier

June, 2008

West Chester Capital

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Introduction

After a near full decade of negligible equity market returns, investors and advisors alike are seeking new tools and strategies to earn returns. Any and all asset classes and returnsets may now merit a spot in an asset allocation by contributing the right return, risk or correlation characteristics.

We are not talking about the Wild West. The efficient frontier is the curve produced by plotting all of the most efficient portfolios on a risk versus return matrix. Efficiency is defined as the best return to risk trade-off for any given point on the matrix. It is expected that rational investors will always want a portfolio that resides somewhere on the efficient frontier. If not, their portfolio is assuming more risk or exposed to a lower expected return mix of assets. That is often a conscious decision, but if it is not, it is needlessly and unknowingly sub-optimal.

Investment strategies continue to proliferate. Long-short, market neutral, 130/30, structured products, covered calls, options as a separate class, private equity, and so on. Strategies that were once considered irresponsible capital market gunslinging are now mainstream strategies. There are two reasons for this: asset allocation and a protracted sideways market.

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Asset allocation is where the efficient frontier is created. The mix of assets drives potential returns and risk. The essential revelation which supports this, for which Harry Markowitz was awarded the Nobel Prize, is that risky assets can be combined to produce less risk, provided they are not perfectly correlated with each other. Theoretically, any asset class could earn a spot in an asset allocation

mix. Some assets earn a spot with returns. Some assets can earn a spot with low risk. Some earn a spot because they have a low correlation to the other asset classes in the mix. As products and strategies continue to proliferate, expanding the efficient frontier is a central investment strategy, and access to a wider variety of returnsets is the key.

After more than eight years of meager equity market returns in the United States, investors are clamoring for strategies to help them earn returns, and money managers are scrambling to devise and package strategies to deliver returns. It is important to remember however, that the markets do have an upward bias, and this is likely to remain true over long periods of time. But as we approach the end of a decade with essentially zero total return from large U.S. stocks, it has become increasingly prudent to seek investment strategies that are capable of earning returns in a variety of market conditions. The ascendancy of hedge funds is due in large part to the search for alternative strategies, which is largely the domain of these private investment partnerships.

Here is the basic go or no go question a prudent investor needs to have answered: Does allocating a portion of my assets in any particular strategy improve my risk and return profile? If so, the strategy may earn a spot in the portfolio. If not, the strategy should not be a realistic portfolio candidate. Once you are willing to ask this basic question, then hypothetically, any strategy could be included. Where stocks, bonds and cash used to be a cutting edge allocation, that same mix is inadequate and imprudent now. After eight years of almost no returns from equities, both private and institutional investors are making significant allocations to a wide variety of non-traditional strategies.

This is for all the right reasons. Well informed and well advised investors must continually avail themselves of the best products and strategies to accomplish their investment goals. Diversification at the asset allocation level is demonstrably more robust than at the

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Founded in 1994, West Chester Capital is a registered investment advisor managing \$150 million of client assets. Located in West Chester, Pennsylvania, West Chester Capital is a wholly owned subsidiary of AmeriServ Financial, a publicly held bank and trust company, headquartered in Johnstown, Pennsylvania. AmeriServ is a \$1 billion bank with a trust company administering \$1.8 billion in client assets.

West Chester Capital manages fiduciary quality portfolios and investment programs for individuals and institutions within a framework of openness, integrity, objectivity and rigorous client advocacy.

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portfolio level. Creating investment strategies that can earn a spot in an institutional or private client portfolio is critical to both product sponsors and clients. Ultimately, we are all interested in the same objective: growth of assets. Clients want their assets to grow. We as investment advisors want our client assets to grow. The alignment is pure. We all thrive together. It serves neither client or advisor to have assets stagnate. It breeds frustration in clients and investment advisors alike.

The sideways equity market of the past eight years has made asset allocation all the more important as the primary tool to deliver investment returns and manage risk. The search for strategies to expand the efficient frontier is endless. The ever expanding menu of strategies and vehicles being created by numerous vendors has raised the bar for all investors and advisors. It has created low cost, efficient access to a broader range of returnsets that can potentially enhance any investor's risk / return profile. The sideways markets have prodded both investors and product sponsors alike to look farther afield for investments that offer characteristics that can enhance an asset allocation.

*Thomas F. McKeon, CFA
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June, 2008*

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