"Life is inherently risky. There is only one big risk you should avoid at all costs, and that is the risk of doing nothing."

Denis Waitley
Motivational Speaker and
Best Selling Author

Risk Management and Asset Allocation

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In the investment advisory business there are a number of ways to describe the roles we perform: financial advisor, investment advisor, investment consultant, financial consultant, financial counselor, financial planner, to mention a few. To try and differentiate these roles would be a difficult task for most people. Other than investment advisor, the term that describes us best is *risk manager*. It defines what we do on a daily basis better than any other. Simply stated, we manage portfolio risk for our clients.

When we start to work with a new client, we begin discussions to determine the amount of risk that the client is willing to assume. These discussions concern their cash flow needs, time horizon, and any constraints they may have. We also confer regarding the client's expected rate of return. Ultimately, the answers to these questions will determine the overall asset allocation of the portfolio. From this information, we create a roadmap for the client which we call an Investment Policy Statement (IPS). Periodically, the allocation outlined in this document will be adjusted to reflect changes not only in the financial markets but also in the lives of our clients as their needs evolve.

The one question most asked by a new client is, "*How can I better understand investment risk?*" To answer that question, we must first accept the premise that *everything has some form of risk.* As a part of our regular course of living, we identify risks inherent in our daily lives and buy insurance to protect against them. Examples are basic life, home, auto, health and disability insurance. The notion of having some form of protection against an event, no matter how unlikely, is an easy concept for most people to understand. If I am sick, I have health insurance to cover my medical bills. If my car is in an accident, I have automobile insurance that covers the cost of repairing my car as well as the other party's car. If there is a fire in my home, my homeowner's policy will compensate me for my loss.

Building an investment portfolio and knowing how to identify the embedded risks that may be associated with it is not as easily understood and certainly not very intuitive to most people. Frankly, it is as much an art as a science for the investment professional as well. There are many variables that can and will affect investment outcome. Suffice it to say, however, the starting point and most important objective is to *control what you can control*. Like the old saying goes, "first, do no harm."

Generally speaking, investment risk can be categorized in two ways: *systemic and un-systemic risk*. Systemic or system risk is also called market risk. This is the risk associated with the financial markets and it *cannot be controlled* since markets fluctuate every minute, hour and day by both seen and unforeseen forces. The economist Adam Smith termed this "the invisible hand" of the markets. This type of risk must be accepted by all investors as part of the investment process and it cannot be diversified away since it is an unknown from minute to minute and day to day.

Un-systemic risk, on the other hand, refers to the risk associated with investing, not in the market as a whole, but rather in the uncertainty that comes with a *particular* industry group or company. It is also known as specific or diversifiable risk. This form of risk *can be reduced* through thoughtful diversification. Simply put, it is not related to the system but rather some subset of the market.

Let's further examine the various components of un-systemic risk. These are risks we can minimize when carefully constructing an investment portfolio. The first is *liquidity risk*. This becomes a concern if a client needs cash, but is currently fully invested. In order to obtain cash to meet the client's need, securities must be sold at current market prices, which may or may not be favorable. This can be controlled by better advance planning and/or keeping cash available and accessible for unforeseen situations.

Conversely, *keeping too much cash for too long*, is the second form of liquidity risk we will examine. This can occur when an investor is risk adverse and fearful of a market correction. Ironically, most investors do not believe they could lose money in a bank money market or certificate of deposit (CD). A simple example will illustrate that if one takes taxes and inflation into account, this can indeed occur. Suppose an investor invests $100 in a one year bank CD, which pays a guaranteed 1% annual interest. At the end of one year, the investor has $101. At a 25% tax bracket, .25% is paid on the interest, leaving the investor with only $100.75. If we factor in an assumed inflation rate of 1.5% during that year, this investor would have lost .75% on their investment. In essence, the investor's purchasing power has been reduced, having lost .75% after taxes and inflation.

The third important risk to evaluate when building an investment portfolio is *interest rate risk*. Over the long-term, interest rates will fluctuate. Sometimes this can happen quickly and in one particular direction. This is important because in finance, models are used to value an asset. A critical input in these models is not only where interest rates are currently but also the expectation of where they may be heading. As rates rise, or are expected to rise, the value of an asset will be affected due to changing borrowing costs as well as comparable yield analysis. What this means is that, given the choice of the same yield, a rational investor should always choose the safer, higher quality security, all things being equal. Keep in mind the saying "money will go to where it is treated best." There are assets that will lose value if/when interest rates rise.

Lastly, a greatly misunderstood risk when managing a portfolio is *opportunity risk*. This is the potential loss from having too many eggs in one investment basket. When markets reverse course, which they will, there is a significant opportunity that will be lost by not being properly diversified. This is a risk that we cannot escape but must simply try to manage. We cannot be in the right place all the time but we can make sure to maintain some form of diversification that meets our long-term individual needs and objectives, and can perhaps help smooth out the ride.

Risk lurks around every corner of our lives. Please take the time to revisit your asset allocation provided to you quarterly. Managing investment risk always begins with this fundamental task. We stand ready to help in any way we can to balance your individual needs with these and other portfolio risks. It is always better to confront and embrace risk than run from it. Remember that there is indeed a risk in doing nothing.
