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Some Additional Ideas on Risk Management

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In the Winter 2013 issue of ***Observations***, we discussed how to manage two specific types of risk: permanent loss of capital and price volatility. Useful risk-mitigation strategies include investing with a large margin of safety and a long-term time horizon, and favoring financially strong and "low-expectation" companies. These techniques and approaches cover risk management at the *individual security* level.

In this article, we discuss some ideas on managing risk at the broader *portfolio* level. You can manage portfolio risk effectively by implementing *asset allocation* and *diversification* strategies.

Asset Allocation

What is asset allocation and why is it a potentially beneficial investment strategy for you? While there are several forms of this strategy with varying complexity, the simplest version involves allocating and investing your assets among three broad asset classes: bonds, stocks and cash.

Asset allocation is beneficial because each of these asset classes exhibits different attributes, with each class showing relative outperformance over different time periods. Asset allocation therefore not only offers you the potential of matching the respective investment characteristics to your individual needs, but also gives you the opportunity to capitalize on the relative strengths of the asset classes over time.

To illustrate the advantages of an asset allocation strategy more fully, let's discuss the respective investment characteristics of the different asset classes. It should be pointed out at the outset that each asset class is itself composed of numerous investment vehicles with varying attributes. For example, a growth stock will perform differently than a cyclical stock. The following discussion focuses only on the general characteristics of each respective asset class without delving into the differences among securities within each class.

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* Portions of this article are copied verbatim from past issues of PDV *Observations.*

Stocks generally offer more potential for capital appreciation, but are subject to a greater risk of capital depreciation**.** Essentially, stocks experience greater volatility. Annual price swings of 30% - 40% between the 52-week high and 52-week low in price are common. Also, dividend-paying stocks may legally suspend dividends at any time, and therefore the income stream generated by stocks is more unpredictable.

Compared to stocks, bonds generally offer less potential for capital appreciation, but are subject to less risk of capital depreciation. Longer-term bonds, however, are subject to greater principal volatility than shorter-term bonds (but you are usually compensated for taking this risk by the higher yields associated with longer-term bonds). Barring defaults by the bond issuers, the income stream produced by bonds is generally fixed at issuance and much more predictable.

Cash has no capital appreciation potential, but is not subject to any principal volatility. However, cash produces income returns that are less predictable than bonds. Income from cash adjusts upwards or downwards relatively quickly to market conditions, while as noted above income payments from fixed-rate bonds are fixed at bond issuance and do not fluctuate.

To understand the utility of an asset allocation strategy, it is necessary to examine the long-term investment records of the three asset classes. Over the past 88 years, stocks have averaged about a 10% annual nominal return; bonds have averaged about a 5% annual nominal return; and cash has averaged about a 3.5% annual nominal return. These are *nominal* figures, meaning they do not take into account the eroding effects of inflation.

Apparent from the above numbers is the tradeoff between risk of loss and potential return. The respective asset classes essentially offer a spectrum of risk/return attributes to which you can match your own goals and needs. The more risk you are prepared to assume as an investor, the more your assets should be allocated to stocks. You should follow a more conservative approach and allocate more to bonds and cash if you have a short investment time horizon, low tolerance for volatility in security prices, a need for income rather than asset growth or would feel uncomfortable seeing your portfolio incur “paper losses.”

While a conservative approach helps mitigate the risk of permanent loss of capital or price volatility, it may lead to significant lifestyle funding shortfalls. For instance, a portfolio highly concentrated in low risk/low return assets may not generate sufficient growth to offset inflation over time or meet your financial goals during an extended retirement period.

The above historical return figures represent average numbers over a very long period of time; they become increasingly meaningless as a reference as your investment time horizon shortens. Both the *absolute* and *relative* performance of the respective asset classes over any one-year period, for example, are likely to deviate substantially from these average historical figures. Knowing your risk tolerance level, financial goals, and investment time horizon are the keys to determining an asset allocation strategy that suits your financial profile.

Diversification

Diversification is one of the most important tenets to successful investing. Simply put, diversification is the idea of spreading your total investment dollars among different investments so that you "don't put all your eggs in one basket." In the asset allocation section above, we covered *diversification among asset classes* (stocks, bonds, and cash); below we discuss diversification *within one particular asset class (stocks).*

Investing in a diversified group of stocks mitigates the risk that a single stock or small group of stocks can ***irreparably*** wreck your financial situation. Also, diversification is designed to reduce the volatility of your stocks as a group, as different stocks have different investment characteristics. The desired result is that some stocks might act well, even as others go through a lackluster period. This increases the odds that at least some of your stocks will be "working" at any point in time.

By convention, many investment managers will implement stock diversification by spreading investment dollars among stocks in different industries and market segments. Here at PDV, we practice stock diversification differently. Instead of following some rigid formula as to how many stocks we should buy in each industry or market segment etc., we diversify by applying our value-driven investment approach consistently over a portfolio of stocks, all possessing financial characteristics that appear to tilt the odds of success in our clients' favor. Though any one investment with favorable odds may not ultimately work out, the goal is to have a portfolio of stocks with favorable odds statistically yield enough winners to generate satisfactory results for our clients' stocks as a group.

At times, our diversification strategy means clients might own quite a lot of stocks in one area of the market, sector or industry that is particularly out of favor, thereby offering the greatest number of undervalued opportunities. Under these circumstances, our clients' stocks might be more concentrated in one market segment or industry than typically would exist in other diversified portfolios, as defined under the conventional method of stock diversification practiced by most other investment professionals.

Another way we diversify is by assembling stock portfolios, one investment at a time, based on a company's operating and investment characteristics. So, for example, steady growth stocks like pharmaceutical companies tend to do better during recessionary times, while cyclical growth stocks like technology companies might do better coming out of a business recession. On the other hand, the progress of special turnaround situations would depend on developments specific to those companies, independent of the business cycle. Assembling a portfolio of stocks with these different attributes will generally result in certain stocks "zigging" while others are "zagging," increasing the odds that at least ***some*** of our clients' stocks will do well at any one point in time.

We also endeavor to achieve diversification for our clients by constructing stock portfolios with stocks possessing different risk/reward profiles. Some are higher risk/higher reward opportunities, while others have lower risk/lower reward qualities. We try to select stocks for clients that fall within ***the entire risk/reward spectrum***, which together are intended to produce the appropriate risk/reward profile for the entire stock portfolio.

Typically, we anchor a stock portfolio with lower risk/lower reward equities complemented by a number of ***appropriately sized*** higher risk/higher return stocks. The more attractive the risk/reward profile of a stock is, the more likely we will add to it. At the same time, the bigger the existing positions in higher risk/higher reward equities, the less likely we will increase the amount of stocks with similar risk/reward profile. To limit potential losses in case the investments do not work out, we don't put too much weight in the higher risk/higher reward stocks as a percentage of the entire equity portfolio. In general, we will take on a larger position in stocks with attractive risk/reward profiles so long as doing so does not cause us to assume an ***overall level of risk*** that is unacceptable.

Concluding Thoughts

Asset allocation and diversification are powerful tools for managing risk at the portfolio level, but they do have limitations. For one, these techniques may be ineffective at reducing risk over very short-term periods and under extreme market conditions. This is because under those conditions, investments that normally tend to perform differently are likely to become positively correlated (in statistical parlance) and their prices will have a strong tendency of moving in the same direction, as we saw during the 2008-09 financial crisis across most asset classes. Over-diversification also presents problems. While diversification can reduce the risk of irreparable losses, too much diversification can limit potential gains, as each winning investment will have only a very small positive impact on the portfolio as a whole.

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