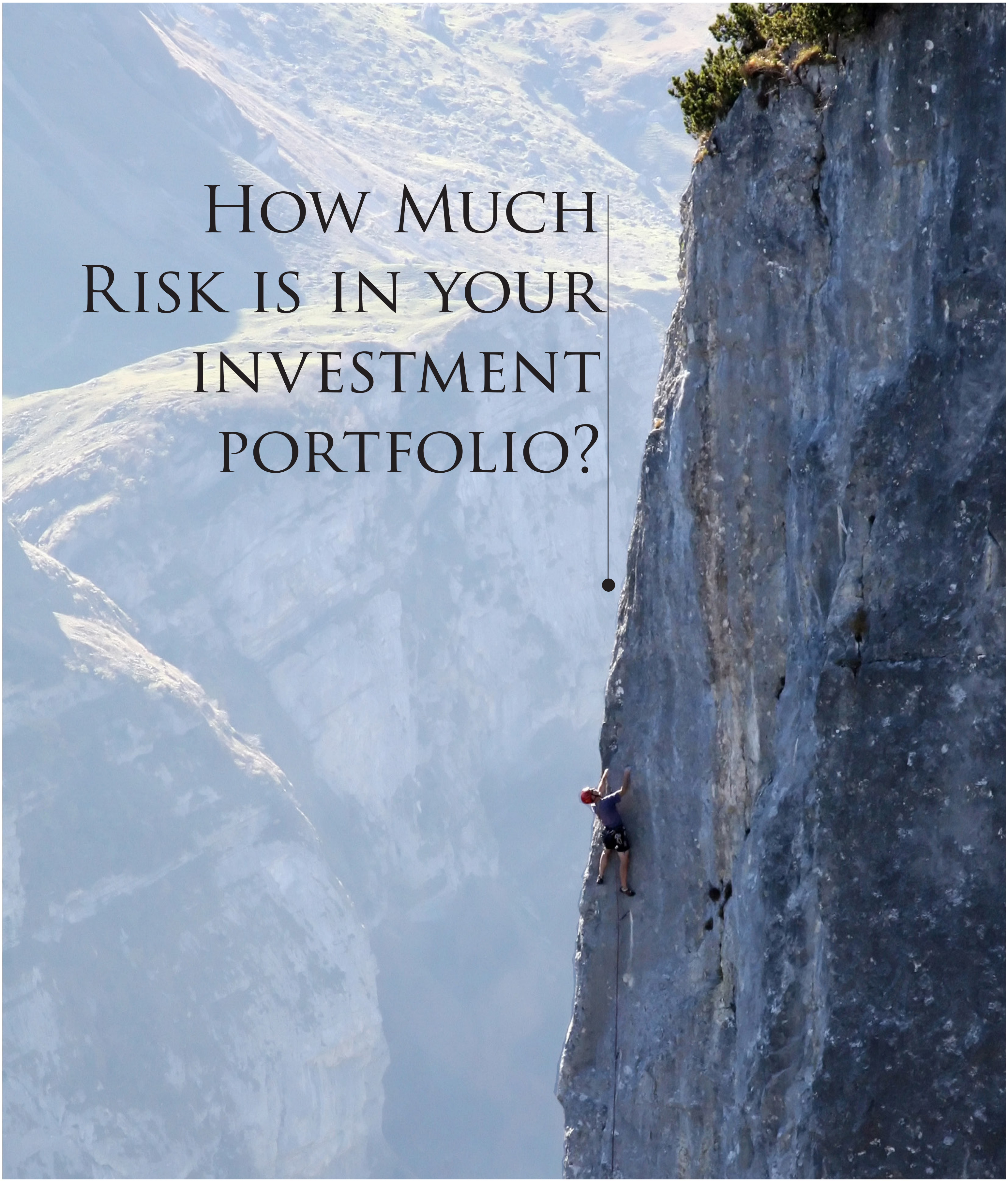
How Much Risk is in your investment portfolio?



Hawley Advisors

HOW MUCH RISK IS IN YOUR INVESTMENT PORTFOLIO?

Do you know how your portfolio would fare in the midst of different market scenarios? How would certain events impact your wealth management and retirement goals as well as your monthly or annual income? How would you manage financially should one or more market events occur simultaneously or consecutively? How will this impact you and how will you navigate amidst the different potential scenarios playing out? These are all questions, an investor or retiree may ask themselves and it can cause you sleepless nights because the future is not here. That being said, being prepared in advance for how to deal with different scenarios can help you deal with the circumstances if they occur.

In our experience many self-managed investors and clients of advisory firms have a pretty good idea of how they're doing in terms of rate of return, but when it comes to understanding how much risk is inherent in their portfolios to achieve that return the waters become less clear. Likewise, investors and retirees are often unaware of how their portfolios are performing against different established benchmarks that account for different levels of risk.

It's a complex matter to compute this so it is understandable that many people do not know how to clearly quantify this. These matters do often register as general concerns and fears that can keep you up at night as you wrestle to find a rational answer.

Fortunately, we have powerful tools available today that can better help us quantify risk under various market conditions, so that you can better evaluate how to manage your way through various market conditions.

These powerful and sophisticated software programs can analyze portfolios and give us many metrics against which to measure performance and risk. For example we can usually find out which assets are contributing "alpha" (excess return) and which are underperforming relative to the objective you're trying to achieve. This is especially important in a portfolio of actively managed stock mutual funds.

We can also get a good idea of how any given portfolio will react in a downturn, as well as how the individual holdings will tend to react. If we want to extrapolate more in-depth scenarios we can also use "Modern Portfolio Theory" (MPT) to plot how efficient the portfolio and it's components are performing and will perform under various conditions.

Think about using these analytical models as a diagnostic tool to see where you might need a "tune up", a part replacement or an upgrade.

One of the most useful parts of putting your portfolio through these exercises is to get an estimate of how much risk is in your portfolio. Most clients equate "risk" with "the fear of losing all their money" but risk is quantified in different ways in the context of professional money management.

In a professional context risk is measured differently and will vary according to the context and objectives of a given client and portfolio which will each have their own risk adjusted mitigation criteria. Let's look at a couple of examples to help illustrate the point.

EXAMPLE 1: PORTFOLIO DESIGN

With respect to the purposes of “portfolio design”, we measure “standard deviation around an expected mean return”. That’s a highly technical term in finance and investment theory that describes how much a portfolio will react to changes in the underlying index, benchmark or other metric.

A very simple way of describing this is to compare two investment portfolios side by side that are designed to attempt to duplicate the annual return of an unmanaged index of 60% stocks and 40% bonds over a five year period. Both portfolios A & B perform exactly the same over the five years; however portfolio “B” is far less volatile over a five year period.

Translated into practical language. If your neighbor held portfolio “A” and you held portfolio “B”, in a market downturn you would be down less than your neighbor. Furthermore, because he is down more in that economic downturn, he has to work harder (take on more risk) to catch up to your return so that at the end of the five year period you both come out the same.

Something to note, and that is often overlooked is the “math of investing”. If your portfolio goes down -35%, it takes +53.8% return to get back to the value of the portfolio before it fell in value.

Hence, we attempt to purposely design portfolios with quantifiable asset allocations and investment combinations that can help mitigate losses in down-turns. However, please know that there are times such as the last market meltdown in 2007 where all asset classes (globally) reacted negatively to the global financial crisis and investment “correlation” disappeared. Said another way, “when the tide goes down that low, all boats in the harbor will be sitting in the mud”.

Why is this important? Because with less volatility in your portfolios, you will sleep better at night. You get a steadier portfolio while achieving the same long term adjusted return as your neighbor. Most importantly, if your portfolio is down less that your neighbor, you’ll be less inclined to pull the plug on your portfolios in a downturn and lock in the losses at the moment when everything seems “darkest”, reacting to the “market fear” and the inevitable “sky is falling frenzy” concocted by the media. By being patient, you can ride out the storm and watch the markets turn around and regain the losses.

In summary, using the examples above even though portfolios “A” and “B” achieved the same rate of return over a five year period, portfolio “B” did it with less volatility and in terms of ‘risk adjusted return investing” portfolio “B” outperformed portfolio “A”. In our ideal world, portfolio “B” would have a higher return AND less risk than portfolio “B”, hence it would be considered a superior and more desirable investment portfolio.

EXAMPLE 2: EXPECTED "EQUITY RISK PREMIUM"

How do you measure "return" in terms of your expected "equity risk premium"? That's a fancy way of saying "how much are you being rewarded by making investments in stocks and bonds over and against the so-called "risk free return of 90 day US Treasury bills"?

All investments have differing levels of risk. However, the short term debt obligations of the US Treasuries have stood the test of time for many, many decades as being the safest in the world when measured in terms of "default risk". The US government has never defaulted on any government debt since 1776! They do carry some risk however. If interest rates were to rise during the ninety day Treasury holding period and you needed to sell them, it is possible that you might receive less dollars in return than what you had bought them for. However the loss would be far less that say a volatile technology stock!

While the matters discussed in this short piece are highly technical, most client grasp the concept fairly quickly and easily, even if they don't fully understand the complexity of the underlying analysis.

We endeavor to "keep things as simple as possible" while acknowledging the complexity in the underlying analysis. We feel it is important that are clients are fully informed when it comes to evaluating "risk" in the context of their "life goals" as it will help establish realistic expectations about their potential portfolio performance over time.

Having a financial advisor who can do the heavy lifting for you by mitigating and adjusting your "risk exposure" based on your life goals can lift a weight of your shoulders. Having a trusted party to help you navigate the inevitable ups and downs of the markets will help you sleep better at night.

As financial advisors and fiduciaries with interests that are entirely aligned with our clients, we are long term partners in this process there to help protect and preserve your financial well-being.

Invitation. You are invited to set up a complimentary, no obligation risk analysis and review of your investment portfolios. You will sleep better at night for doing so! Just call or email us using the information below.

We look forward to meeting you and answering any questions you have.

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HARRY'S PRICELESS INVESTING LESSON

Early in my career, in 1985, I was hired by a bank to provide financial services to some of their clients who were searching for alternative investments beyond the traditional certificates of deposit that the bank offered. The stock market had risen from the dead after the 1970's and starting in 1982 we saw the beginning of the greatest bull market in history which ran for a full 18 years. By 1985, the returns on the certificate of deposits were being dwarfed in comparison to the returns seen in the market. They wanted in!

For the next three years, the market was strong and surging to new consecutive highs. My clients, needless to say, were happy! On October 19 1987 (Black Monday) the Dow Jones industrial average suddenly and without explanation plunged 508 points or a full -24.39% in a single day. It was then and remains to this day, the largest stock market drop (in percentage terms) in a single day.

To say that it was terrifying was a vast understatement. I really thought that the stock market would go through a devastating collapse and that the economy would soon follow, and that I would soon be looking for a new career. I stayed on the phone all day trying to reassure panicking customers, some of whom had lived through the great Depression.

Right before the closing hour of 1pm on October 19th, 1987 I received a call from a new client. He said

"Dan…here's a list of stocks I want you to buy for me today". I replied…"Harry…are you out of your mind…don't you understand what's going on"? He calmly replied…"Yes, I do…you won't see prices this good for a long time".

Harry had survived WWII, being shot at countless times, flying a small unarmed artillery observation plane in the front lines looking for targets in Germany and France. Like many in their "Greatest Generation" who had also grown up following the market crash of 1929 and the subsequent Great Depression, he had known lots of hardship and fear. A little stock market down turn in the midst of a bull market was a minor worry.

Sure enough, Harry was right and while I stayed late into the night fielding calls from panicked investors who wanted to sell at the next day's opening, he captured great bargain prices for the stocks on his "buy list". Many investors know that the biggest down day in history was October 19, 1987, but they don't know that the seventh greatest one-day rise in stock market history was on October 21st (the next market open-day when prices soared by 187 points. (The market was shut down and closed on October 20th). The market went on to make a full recovery in less than 18 months.

It's a well know axiom in investing that panic selling is usually followed by reticent reentry into a market that usually moves very strongly off a market bottom. Selling into the "fear" may make you feel better in the short-term but after the "fear" has subsided and given way to rational thought, the damage has already been done. You now have to play catch-up to meet your investment goals and to do so, you may be tempted to wilder speculation and higher risk which can create a negative cycle of further losses.

January 4, 1999 to December 31, 2018	Dollar value	Annualized Performance
Fully invested (S&P 500 index)	$29,845	5.62%
Missed 10 best days	$14,895	2.01%
Missed 20 best days	$9,359	-.33%
Missed 30 best days	$6,213	-2.35%
Missed 40 best days	$4,241	-4.2%
Missed 50 best days	$2,985	-5.87%
Missed 60 best days	$2,144	-7.41%

SOURCE: JP MORGAN.

Note that the S&P 500 stock index is an unmanaged group of the 500 largest companies over certain periods of time. You cannot invest directly in an index, only in a proxy, such as a passive index mutual fund or Exchange traded fund (ETF).

https://en.wikipedia.org/wiki/Black_Monday_(1987)

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WEALTH PLANNING

YOUR EXCLUSIVE INVITATION

Are You Prepared for What's Ahead?

You are invited to an informal no-obligation chat with us to discuss your questions and goals. If, after our meeting, you would like us to do so we will provide you with a complimentary and no-obligation risk analysis which will include a "Riskalyze" assessment.

To set up your complimentary meeting
please call us at 925.906.9800
or email us at: clientservice@hawleyadvisors.com

We look forward to meeting you and answering any questions you have.