The CJ Investment Newsletter
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Investment Risk

Purpose

This is a reissue of previously disseminated information.

The *CJ* Investment Newsletter deals with the entire spectrum of securities investing, including cash (money market funds), bonds, equities and options. It will evaluate the overall investing environment and then discuss the relative allocations of these asset types, as well as strategies to implement within them. Essentially, it reflects what I'm actually doing with my clients.

These letters are not sent "cold." Either I know you or someone you know gave me your name. Yes, this letter *is* a sales tool. It communicates how I apply my investment strategies, so that you can decide, without any sales pressure, if my thinking is compatible with how you want your money invested. If you're not already a client, I would like to discuss your *becoming* a client. Please call me for more information.

However, that's not its only purpose. Even if you never become a client, if you want this information, I want you to have it – for a while, anyway. My hope is that providing this information and teaching you what I think is important when investing may help you. Please contact me if you have any questions or comments. I'd love to hear your reaction to my letter.

Quick Look

Market	Next Expected Move
?	

- I discuss investment risk this month. This term and the concepts that surround it are used and misused extensively in our culture. I will try to clarify what it is and how to deal with it this month. I won't attempt to be all-inclusive here, but I will try to isolate the most relevant issues, misunderstandings and constructive ways to think about and mitigate investment risk.

Risk "Defined"

Risk the noun is defined in my famous old Webster's New Collegiate Dictionary, 1973 edition, as: "possibility of loss or injury: PERIL" and "the degree of probability of such loss."

In the Encyclopedic Dictionary of Accounting & Finance (EDAF) by Shim & Siegel, 1989 edition, risk is discussed extensively and quantitatively, but some of it isn't directly relevant to investment risk. That said, they define accounting and finance risk as: "The variability of cash flow (or earnings) around the expected value (return). Risk can be measured in absolute or relative terms. Statistics such as *standard deviation* and *coefficient of deviation* are used to measure risk."

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*** *Have a Happy & Prosperous New Year* ***

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Types of Risk

Again, from the EDAF, here is their list of different types of risks:

- *Business risk* – innate to the individual company or stock. Includes risks of annual business losses and continuing entity concerns.
- *Liquidity risk* – the risk that if an investment needs to be liquidated quickly, the price drop from market or book price may be substantial. Mostly real estate, but there are others.
- *Default (Credit) risk* – the risk that the borrower of a debt security will be unable to pay the interest and/or principal.
- *Market risk* – systemic risks associated with market forces and not any individual security.
- *Interest rate risk* – the sensitivity of the price of a security to changes in market interest rates. More important to securities generating cash flow for the investor than for growth stocks.
- *Purchasing Power (Inflation) risk* – The risk that principal repaid or investment sale proceeds will be worth less than when the security was purchased. More of a certainty in an economy with a central bank.
- *Nonsystematic risk* – the risk that can be controlled by diversification, whatever that means.
- *Systematic risk* – risks to a security over which it has no control. Includes market risk, interest rate risk and purchasing power risk. This risk is measured by the beta coefficient.

I made a couple of small changes in order to add brevity and (I hope) clarity and inclusiveness to the list, but it is consistent with the spirit in the EDAF.

The list is somewhat complete, but upon further consultation and reflection, three real risks not on that list should be described:

- *Currency risk* – the risk of loss due to relative changes in currency value. This is particularly true in our ever-more globalized world.
- *Foreign risk* – the risk of loss from operations in countries with less friendly or stable governments, including the complete loss of operations from nationalization of operations within that country without compensation to the rightful owner(s).
- *Political risk* – the risk posed by changes in domestic government interference and/or control of parts or all of the economy. Examples: changes in tax policy, monetary policy, laws and programs (*e.g.* social security, healthcare). Also, changes in the level of government controls either economy-wide or in specific segments, including increased regulation and/or deregulation.

The Risk – Return Tradeoff

Most of you have heard me say or write that most people misunderstand the nature of risk and return. It's not uncommon to hear (even on CNBC!) that if you buy riskier investments, you will get a higher return. This is awkward thinking at best and backward thinking at worst.

From the EDAF: "The investor must compare the expected return from a given investment with the risk associated with it. *Generally speaking, the higher the risk undertaken, the more ample the return (expected)...*" The point is, taking higher risk does not *provide* a higher return; the investor *demands* a higher return in exchange for taking a higher risk.

Perhaps this is best illustrated with bank loans or bond issues. Borrowers with large resources and healthy financials will be able to borrow at lower interest rates than smaller, more speculative borrowers with less certain income prospects and more suspect balance sheets. The latter group is more risky. Therefore, lenders or bond purchasers *demand* higher interest rates to compensate for the higher risks associated with the latter borrower.

The same should be true of stock investments. If total equity returns for a stock are not commensurate with the additional risk incurred by a growth stock *versus* a large cap dividend paying stock, then that growth stock should be sold and replaced by another stock that provides a return commensurate with its risk

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Asset Allocation Percentages
CJ Current Suggested Ranges

Dow Theory Market Phase: **BEAR**
Appropriate Current Allocation: **DEFENSIVE**

Asset Class	Conservative	Aggressive
Money Market Funds	70-10%	55- 5%
Long Positions:		
Bonds & Bond Funds	30-60%	40-60%
RD Stocks	0-10%	0-10%
Growth Stocks	0%	0%
Gold Equities/Funds	0-20%	10-30%
Bear Market Funds	0- 10%	5-20%
Aggressive Positions:		
Shorts and/or Options	0%	0- 5%

Notes:
Income generating portfolios may not conform to the above guidelines. If income is the primary purpose of a portfolio, income needs are met *first*, then other allocations are made.

Up to 50% of bond/bond fund positions should be in international (non-US) bonds. Such bonds will provide higher interest paid on the face due to the additional *perceived* risk of foreign bonds, as well as providing hedging gains as the dollar declines against foreign currencies due to Fed monetary policies.

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Dealing with Risk

First, forget about buy-and-hold. History doesn't treat this strategy very well. Things change too quickly. This strategy probably *increases* your long-term risk.

Diversification is not a risk management panacea, either, although Wall Street would love you to believe otherwise. Diversification, at its best, keeps the decline of a single security or investments in an industry segment from killing your portfolio. In other words, it can protect you from having a single investment or small group of investments from destroying your portfolio in the case of an *isolated price decline*. Market-wide declines are not mitigated at all by diversification within those markets. A broad-based bear market can wreak serious damage on even the most diversified of portfolios – as we have seen since Q4, 2007. Cash is much more protective than diversification at such times.

Diversification is necessary, but as I often say, many people are over-diversified and under-protected. My favorite example involves an illustration of a "typical" broad market mutual fund, if there is such a thing anymore. Assume it has 100 stocks (not an unusual number) and that each makes up 1% of the fund. What happens if one stock loses 50%? Nothing! It's a speck. What happens when a stock doubles? Nothing! It's a speck, also. In such a fund, you are practically guaranteed to get a market return, less any management fees charged to the fund. In a bear market, the fund will tank, just like the market. This is a classic case of being over-diversified and under-protected.

Use of the capital asset pricing model (CAPM) (also known as the security market line, SML) measures the risk through a measurement called beta and relates it to the "required" return on a security. Beta is a coefficient that gives the user a measurement as to how volatile a security (or ETF or fund) is related to an index, most commonly the S&P 500. In other words, use of CAPM, if properly done, can help guide an investor in the mitigation of systematic risk. CAPM is an ingenious system and widely used, but not without its own weaknesses.

The book Trend Following, by Michael W. Covel, points out some of these weaknesses, beginning on page 226: "Volatility around the mean (standard deviation [signified by the Greek letter sigma – CBJ]) is the standard Wall Street definition of risk… We are influenced heavily by standard finance theory that revolves almost entirely around normal distribution worship." The problem happens when price changes are not normally distributed.

If the distribution curves show large enough skewness or kurtosis, (measures which change the shape and, therefore, the risk and return characteristics of the distribution curve) the use of sigma, beta and CAPM become much less meaningful, and, at some point, downright misleading.

The point is, use tools, but remember that you need a *toolbox*, not a single tool. Risk can be measured and mitigated to some degree. Currently, I use fundamental and technical analysis, economic analysis, industry segment analysis, diversification and common sense portfolio and cash management techniques to attempt to mitigate risk. Think of it like driving a car. You use your eyes, ears, and senses of touch and smell to detect danger signals in order to avoid trouble and to drive your car to its intended destination with as few problems as possible.