


Securities Risk Management

Quick Look

<u>Market</u>	<u>Next Expected Move</u>	<u>Month</u>	<u>YTD</u>
?			
DJI		0.82%	0.85%
COMP		3.11%	1.58%
SPX		2.10%	4.07%
Gold		-3.43%	4.11%

- We discuss securities risk management in the context of portfolio protection. The common tools used are described, including their strengths and weaknesses.

Securities Risk Management

It's been quite a while since we've looked at securities related risk management in the *CJ Newsletter (CJ)*. Given how the securities markets are acting currently, it seems appropriate to review how securities risks can be managed or mitigated. Since one hears so much about diversification in the media, we will closely examine the role of diversification in the securities risk-management process.

To begin with, here is a list of investment risk management tools:

- *Diversification*, of which there are two primary types:
 - Between asset classes
 - Within asset classes
- *Insurance*, which is generally contractual. There are also two primary types:
 - Individual contracts
 - Options contracts or combinations of options. These contracts are securities traded on exchanges.

- *Inverse securities*, securities that move inversely with an underlying security or index of some type.
- *Cash*, including foreign currencies.
- *Non-securities Assets* such as land, businesses, precious metals and gems, commodities and fine art, among others.

With some thought, the general principles of securities risk management appear after reviewing the list of tools. Securities risk management is accomplished via:

- Tools which directly deal with the risks associated with securities investments, namely the first three tools.
- Tools which avoid the inherent risk in securities through investment in non-security assets, namely the last two.

There is a large list of different risks associated with owning investment securities. Rather than list them here, they will be discussed in the context of their management (below).

Diversification

Before beginning any discussion of diversification as a securities risk management tool, it is critically important to remember that diversification **ONLY** protects an investor from having the decline of a **SINGLE** bad investment (decision) destroy the value of an investor's portfolio and, therefore, his/her entire net worth. That's **ALL** it does. Diversification is **NOT** a panacea.

Therefore, if all of your investments are in stocks and the stock market crashes, you have **NOT** been protected, no matter how many different types, industries, *etc.* you "diversified" into.

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Diversification certainly didn't "protect" stock investors in the common sense meaning of the word in the bear markets of 1929, 1987, 2000, or 2008, just to name a few.

As mentioned above, there are two main types of diversification. They are diversification:

- between asset classes and
- within asset classes.

Diversification between Asset Classes; Using Non-securities Assets

Investing in non-securities assets avoids some of the risks associated with securities investments. They constitute how to diversify *between* asset classes. Investments in non-securities assets each have their own risks, and there is *some* risk overlap associated with them and securities. There are also *securities* that allow for investment in non-security asset classes, such as precious metals and commodities. These special securities also can help manage risks related to both ownership of non-securities assets and/or their associated securities, primarily through options and/or futures contracts. While the classes become blurred and confusing with all these alternatives, diversification between classes can still help mitigate some of the risks specific to securities investing through avoidance.

Diversification between classes is the more effective of the two types of diversification in the case of a stock market crash. Non-securities investments may not be damaged as badly as stocks in a stock market crash. Still, they are not immune to damage during such events. In some cases, some assets such as precious metals coins or bars may actually appreciate in value for a while, if the "flight to quality" behavior is exhibited by large numbers of investors. But, this doesn't always happen.

Other disadvantages to using diversification between classes are generally attached to the types of non-securities assets used:

- *Liquidity* – Land, businesses, precious metals and gems, fine art are all not liquid, other than metallic coins of known mints, weights and purities.
- *Nominal value* – In sideways and bull markets, such assets may have high demand, leading to high nominal values. In bear markets, depending upon the specific situation, such assets may flood their markets as owners try to convert to cash, causing their market value to decline.

Diversification within Asset Classes

Diversification for diversification's sake alone can be counterproductive. Assume an index is composed of say, 30 different industries. An investor has reviewed the industries involved and has decided based upon considerable fundamental and technical analysis about these industries that 9 of the 30 industries (30%) will underperform for the next four quarters (1 year) and that 5 of these 9 industries (approximately 18%) will most likely suffer losses during this period. Why in the name of *diversification* would an intelligent investor invest in securities for those industries for the next year if that were the case? If he/she was convinced of the accuracy of his/her analysis, he/she would not purchase positions in the underperforming industries and if positions were already held, those positions should probably be sold.

Optimizing Position Size

Diversification also has another side. *Dilution* is what happens to portfolio performance when a portfolio contains "too many" positions. How much is too many? It depends upon the investor, but a different anecdote may illustrate the principles involved. Let's assume that a mutual fund contains 100 positions, each valued at 1% of the total fund asset value. What happens to the value of an investment in that fund if one of those positions declines by 50%? Essentially, nothing – the value of that investment declines by ½%, which is, basically, a *speck*. In the big picture, it's not very important.

But what happens if one of the positions doubles, that is, appreciates by 100%? It's *still a speck*. There are so many positions in the portfolio that it pretty much takes a general bull market for the fund to provide a significant return. Especially after fund management fees and particularly if the fund charges load fees. Having 100 individual positions in an individual portfolio compounds the expense problem without adding any benefit on the revenue side. Unless the individual account is enormous, transaction friction could consume most or all appreciation benefits, even in a weak or medium bull market, possibly driving the portfolio into a loss position despite the ostensive bull market.

So, 100 individual positions are too many. The dilution of the return from so many positions would outweigh the amount of mitigation of the portfolio risk.

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Back in the dim past of my life when I worked as an accountant, I seem to remember that ERISA qualified plans required a minimum of 20 positions (among other requirements) to be considered diversified. After Googling to see if this was still true, I can find no evidence that requirement ever existed. Nonetheless, let's consider that a regulated standard just for the sake of examining whether that is a reasonable standard. And a reasonable minimum number of positions.

If a portfolio must contain a minimum of twenty positions, it would then be reasonable to assume that the requirement is actually saying that no one position should exceed 5% of the total portfolio valuation. In other words, a single position that exceeds 5% of the portfolio would be deemed "too large." It would constitute too much risk to the overall portfolio. After all, the entire purpose of diversification is to keep the decline of a single security from destroying the value of the entire portfolio.

Asking the same questions we asked before, what happens if a 5% position declines by 50%? That's a 2½% loss. It is no longer a speck, but as a single loss, not at all crippling to the portfolio. What happens if the security doubles? Ahh, there's the rub! Unless the position doubled virtually overnight, portions of the position in excess of 5% of the portfolio value would be required to be sold to keep from exceeding the 5% maximum! In other words, *the portfolio has to sell its winners, but can let the losers ride* if the manager so chooses. Does that seem like intelligent investing?

Especially considering transaction friction, such rules would seem to all but prevent such a portfolio from ever performing at a high level. Perhaps the only answer would be to increase the number of positions to 40 (double them), thus allowing a 100% increase in the value of the position, as described in our 100 position portfolio above. But, wait. Each position would then constitute only 2½% of the portfolio.

Asking our questions one more time, what happens if a 2½% position loses 50%? A 1¼% loss. While not a speck, it's not an important loss either. The portfolio could easily still perform well in the face of such a loss. What if the position doubled? That would constitute a 2½% gain, which would be significant, although not nearly as significant as if our 20 position portfolio was able to realize the full 5% gain it could have except for the 5% maximum position size limit.

After thinking these scenarios through, we now have the ability to decide how to optimize the competing

goals of minimizing risk through diversification and diluting return from overdiversification. In general, I tend to favor a portfolio with between 15 to 25 or 30 positions, depending upon the quality of the individual prospects available and the overall market conditions.

Of course, there would be no arbitrary caps on individual position size. Clearly, one should realize gains from security appreciation by selling some or all of that position, especially if those gains exceed expectations and/or indications are that valuation will NOT hold or appreciate further in the future.

Where would position size alone become a reason for selling part or all of a position? In my opinion, somewhere over 10% but less than 20%. A significant loss in a position representing that large a part of a portfolio would clearly damage short- to intermediate-term prospects for a portfolio. If a position becomes that large, I review it frequently for both news and for chart indications that its bull run may stop and reverse.

Insurance

Insurance as used in this context simply means the purchase of contract(s) with other party (or parties) specifically designed to indemnify an investment portfolio, in whole or in part, from losses incurred if specific insured risks actually materialize and the value of an investment portfolio is adversely affected as a result. This is analogous to fire insurance on a home or auto insurance.

As alluded to above this can be done in essentially two ways:

- Insurance contracts (policies) offered by insurance parties as either a standard product or specifically underwritten for a particular portfolio.
- The use of options contracts or combinations of options contracts, which are derivative securities, traded on certain exchanges. Use of these securities, if properly structured, can protect a portfolio from specific risks materializing.

Derivative securities, or simply *derivatives*, are securities whose values change (*i.e. derived*) based upon the value or price movements of an *underlying security*. Options are simply one of several types of derivative securities.

There are always costs to having such protection, however. Insurance, including the use of options contracts, can protect the securities they were designed to protect, but money must be spent in order to

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purchase this protection. When these contracts expire, they must be purchased again to maintain their protection. The amounts spent on these contracts cannot be used on earning assets, so ***the amounts expended will lower the overall return on the portfolio*** directly from the amounts expended and indirectly as opportunity losses from not purchasing assets that would earn and potentially compound.

Inverse Securities

As mentioned above, inverse securities, as used here, are securities that move inversely with an underlying security or index. These are generally derivatives, but there exist non-derivative securities that also would belong to this category. If the underlying security declines, the inverse security appreciates and vice versa. Some of these securities move in multiples to that of the underlying security. Therefore, they can protect a “long” portfolio’s value from a generalized market decline or from declines in more specific industry or geographic segments, for example. Of course, if the underlying security appreciates, the value of the inverse security declines.

The big advantage I see to these securities is that, unlike insurance, options and futures contracts, they don’t expire. It’s possible they could become severely devalued if the underlying security appreciates for a long period, but it would be unusual for them to become worthless. Regardless, the most an investor can lose from these is their original cost.

Some leveraged ETF’s and particularly leveraged *inverse* ETF’s are derivative products that some government agencies consider controversial due to a characteristic called “tracking error.” For a full discussion of this issue and my thoughts see the

8/2010 *CJ*, entitled “Bear Market Tactics, Tracking Error and the SEC.” The issue is available on the TCM website, the address shown on the bottom of each page of the *CJ*.

Cash

The old saying: “Cash is trash.” Catchy, but cash is as “safe” as any investment could be. Any weakness in holding cash is due to irresponsible government policies. Since 2008, cash returns almost nothing, but for most of the last 115 years, that has not been the case. You can blame the Fed, but not cash for that. Cash is a valid and safe investment choice at all times, but especially in risky times. Through avoidance, cash mitigates the risk of market losses. In dangerous times, larger cash positions are both reasonable and important. (You may also wish to read my 2006 article about cash. See the TCM website media archive section.)

Putting it Together

These tools can be combined in a myriad of ways to help mitigate portfolio securities risk. Each has its place and purpose. However, one thing that is not often discussed is that there are ***two*** guidelines that should drive portfolio construction: client risk tolerance AND overall market risk. The two often intertwine, but the portfolio manager needs to assess and deal with both drivers, not just client risk tolerance. In the late 1990’s, almost everyone seemed risk tolerant. There was no perceived market risk, just like today. They were wrong. No matter how risk tolerant a client seems, no one likes to lose money, especially a LOT of money. Good portfolio management tends to become easier to recognize in bear markets than in bull markets.

Purpose

The *CJ* Investment Newsletter deals with most of the spectrum of securities investing, including cash (money market funds), bonds, equities and derivatives. It will evaluate the overall investing environment and, from time to time, discuss the relative allocations (including avoidance) of these asset types, as well as strategies to implement them (individual stocks or bonds, CEF’s, ETF’s, open-end mutual funds, and derivatives). Essentially, it reflects what I’m actually doing with my clients.

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 consider important when investing may help you. I’d also love to hear any questions or comments you may have about my letter.

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 analyze the markets and economy, as well as 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 contact me for more information.