Summary of Key Points

-- The market crises of 2000-2002 and 2008-2009 have caused investors to place more focus on risk management.

-- Not all risk management tools are likely to be effective. Backward-looking analysis is limited in value because the future is likely to be different from the past. We don’t favor this technique.

-- When stock put options are purchased as a risk management tool, they are likely to be effective in limiting losses, but they are too expensive to use. We don’t favor this technique.

-- Investors should focus on risk that is most likely to be relevant to them - permanent loss of principal. Our focus on this risk helps us to identify the largest likely pitfalls and help avoid certain investment behaviors.

Risk = Permanent Loss of Principal

Risk is often misunderstood. When professionals emphasize quantitative measures to identify risks that are relevant to a portfolio, they may actually create too great a focus on short term performance. This may lead them to manage risk ineffectively. In reality, the risk that is most relevant to long-term investors is the permanent loss of principal; that is, losing money on investments that never recover. Our focus on this as our clients’ primary risk helps to define our approach to risk management.

This paper reviews the merits of backward-looking strategies and the purchase of put options to reduce portfolio losses. Based on our analysis, we do not believe that these strategies make sense for the long term. We will identify risk management approaches that we feel are more effective.

Driving While Looking In the Rear View Mirror

Since 2000, the U.S. equity market has experienced lower returns and higher risk than we have seen in some time. The bursting of the dot com bubble (2000-2002) and the 2008-2009 financial crisis heightened investor focus on risk management. Effective risk management requires that investors pick the right tools to meet the challenges posed by excessive volatility, such as the large market downturn in 2008. Many hedging and risk management strategies were proposed (after the fact) as potential solutions to that sort of catastrophic market event. Their proponents present them as backward-looking tests and simulations of what could have been had the investor followed one particular strategy versus another. The fundamental issue with many of these strategies is not that they are unlikely to work well in protecting against another 2008. It is that every market crisis is unique; it is not reasonable to expect the markets to behave the same way in every crisis. It is altogether possible that a backward-looking strategy that might have protected against the decline in 2008 will fail to protect a portfolio during the next crisis.
Stock Put Options Work – At What Cost?

There are a number of risk management methods that we believe are likely to work as intended in the event of a major market decline. One such method is buying put options that protect against declines in market prices of stocks over a given time period. One way to think about put options is to compare them to insurance. In an insurance contract, the buyer pays a premium and expects to be paid a certain amount by the insurance provider if a particular bad event occurs. In the case of a put option contract, an investor would buy the put option (effectively paying a premium to the seller of that contract) and expect to be protected against market declines as a result of that contract.

Although put options are likely to be an effective tool to protect against sudden market declines, their effectiveness as a long term tool is limited by the upfront cost of the premiums required to buy the protection. For example, as of the end of October 2011, the S&P 500 Index closed at a level of 1253.30 points. A put option to protect against declines in that index below the 1250 level for the next 11 months was offered for sale at $125 per contract. Effectively, that means that to protect his value in the index against any material declines below its present level over a little less than a year, an investor would pay almost 10% of the portfolio value that he wanted to protect, in premiums. The cost significantly limits the upside potential of the portfolio – the value of the stocks held would need to appreciate at least 10% for the investor to simply break even.

Our Risk Management Approach

As mentioned earlier, in its simplest form, we define risk as the permanent loss of principal. In other words, in our opinion risk is losing money and not making it back. This is most likely to happen to investors under the following circumstances:

1. They sell out after market declines and do not participate in the rally;
2. They are too concentrated in any one stock or any one asset class; and
3. They are faced with low returns as they start to draw down their portfolio for living expenses.

Effective, holistic risk management should be employed to address all three of these possibilities.

Managing Emotions

Effective risk management begins by addressing a problem many investors face—the instinct to react to significant market declines by selling their holdings at lower prices and then not enjoying any rally that could follow. This is best managed through a multi-pronged approach. First, clients consult with their Wealth Manager to determine their risk tolerance (ability to withstand declines in the portfolio’s value), and long-term return objectives. The portfolio is established with a level of risk that is consistent with the client’s risk tolerance. Sometimes, the Wealth Manager helps reconcile the situation when the client’s risk tolerance is too low relative to the desired return that is needed to achieve their retirement objectives.

Emphasis on Diversification

Over-concentration in any one stock or one asset class can put a portfolio at significant risk. It is far more likely for any one stock or asset class to face significant declines in value (that are not recovered) than it is for a broadly diversified portfolio. For example, Japanese stocks have yet to recover their losses of the late 80s and early 90s.

A useful way to protect against such declines is through diversification. By including many different asset types in portfolios, with a diversity of different business models, an investor is less likely to be affected by a significant decline in any one company or any one group of assets.

Risk for the Newly Retired: Low Returns

Clients who are nearing retirement or are newly-retired face the risk that returns will be low during their first years of retirement. If they react emotionally, they may feel compelled to sell their investments at lower values to fund living expenses. By selling out, they won’t have the opportunity for their investments to rally later on. While this is risk is difficult to prevent, investors can help improve their reaction by understanding the possible impact on their entire financial picture, in
Monte Carlo is a sort of stress test on a retirement portfolio that simulates hundreds of potential lifetimes of investment returns. The analysis helps the investor to understand the likelihood of achieving his/her retirement funding goals. Some of the simulated lifetimes will include lower returns in the retirement years, lowering the probability of success. Investors can study this probability and make adjustments to their spending, saving rate, and risk tolerance to create a probability of success with which they are comfortable.

Conclusion

Investment analysis and portfolio construction frequently boil down to two simple qualities: returns earned relative to the risks taken. Most rational investors seek to achieve the highest possible returns for a given level of risk and most will consider all reasonable ways to reduce overall risk. However, reacting to the recent past with backwardlooking strategies that mitigate the most recent crisis may not be the most effective tool. Nor is it desirable to pay away significant portions of a portfolio’s value to secure outright protection against potential declines through the purchase of put options. While no strategy can protect a portfolio entirely, to help protect a portfolio against the permanent loss of principal, investors should work with their RegentAtlantic Wealth Manager to diversify their portfolio, react rationally to market downturns, and prepare for the possibility of low or negative investment returns early in retirement.

Important Disclosure Information

Please remember that different types of investments involve varying degrees of risk, including the loss of money invested. Past performance may not be indicative of future results. Therefore, it should not be assumed that future performance of any specific investment or investment strategy, including the investments or investment strategies recommended or undertaken by RegentAtlantic Capital, LLC ("RegentAtlantic") will be profitable. Please remember to contact RegentAtlantic if there are any changes in your personal or financial situation or investment objectives for the purpose of reviewing our previous recommendations and services, or if you wish to impose, add, or modify any reasonable restrictions to our investment management services. A copy of our current written disclosure statement discussing our advisory services and fees is available for your review upon request. This article is not a substitute for personalized advice from RegentAtlantic. This information is current only as of the date on which it was sent. The statements and opinions expressed are, however, subject to change without notice based on market and other conditions and may differ from opinions expressed in other businesses and activities of RegentAtlantic.