PORTFOLIO WATCH

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It's Not All About Reward

A number of years ago my wife's dad gave her a compound hunting bow. That's the kind with pulleys and levers that allow you to shoot an arrow about as far as an ICBM. We put it in the garage with no idea what we were going to do with it, but our son came up with a plan. He and a buddy took it to the lake and spent the afternoon shooting arrows straight up, and then trying to catch them on the way down (I've used this analogy before, and I'm still not making it up). I counseled him that this may not have been the best idea, which he had a hard time understanding because "nobody got hurt." The point was not whether they had a good time or not…it was the risk they took to do it.

Looking Backwards

"Risk" gets talked about a lot, but it's seldom understood even by investment advisors. The problem is that risk is forward-looking. Risk is the chance that something…which hasn't happened yet…may happen in the future. But we assess investment performance by looking backwards, and risk completely disappears when we look at historical performance. It's no different than my son justifying his arrow-catching activities because he didn't end up with an arrow replacing his eyeball. We are currently at a time where many investment advisors and fund managers are pounding their chests because they performed well over the last 8 years. In fact, the best-performing portfolios were the ones that were the least-diversified and paid no attention to risk. But this is looking in the rearview mirror after everything that happened *has already happened*. The risk is now gone and forgotten and the only thing we see is the reward. A great example is the "fiscal cliff" back in 2013. All risk managers lightened up on stocks or hedged the downside because of the increased chance of a devastating

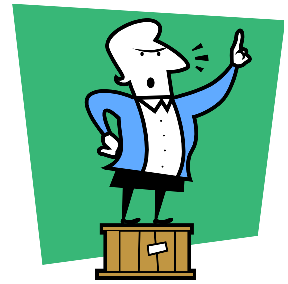
loss. When it was over and doomsday didn't happen, the money managers who never pay attention to risk were viewed as brilliant. The risk was gone and, this time, they came out ahead.

Time as a Risk Management Tool

Investors who are "in it for the long term" and plan to ride out the bumps in the market will often say that time is the best risk-management tool. By looking backwards, we see that the market has always recovered from downturns. Of course, precious time is lost while waiting for the recovery and that could devastate your financial goals if it happens at the wrong time, but it's easy to pick a point A and a point B in market history that proves how well a portfolio devoid of risk management works. Unfortunately, your financial goals do not fit nicely into a historical time period. To accomplish financial goals we have to look forward, and that involves risk…always.

Balancing Risk and Reward

Performance must always be looked at in the context of the risk it took to get there. It doesn't matter what ended up happening in the market once we're able to look backwards, any more than avoiding an arrow in your forehead makes playing catch with arrows a good idea. If you put your savings and retirement funds at risk, the risk should be defined and risk-management should go beyond hoping that history repeats itself in the timeframe you need it to. This goes against the prevailing idea that cost is everything and therefore you should buy the least risk-managed index funds possible. If you're not a fan of risk management, my son may be looking for someone to play catch with.



Market Comments

Risk has been on my mind quite a bit lately…even more than usual. The average time between a 5% market correction is about 10 weeks. It's now been well-over a year since the last 5% drop. A 5% correction, though, is not going to derail too many financial plans. A 20% correction, on the other hand, could have a significant impact if you're not prepared for it. The typical time between 20% corrections is about 2.5 years, and it's been over 8 years since the market bottomed in 2009 and started its march higher. This is the longest bull market run without a significant correction. Does this mean a big correction is coming soon? I have no idea. But it has been getting me to think about risk…even more than usual.

Risk-management has become tougher in the last couple of decades. It used to be that owning foreign stocks was somewhat of a hedge against a loss in U.S. stocks. Globalization has pretty much eliminated that. Owning small company stocks and large company stocks was even somewhat effective in reducing risk, but does anyone really believe that owning some small energy companies reduces the risk of owning large energy companies? Diversification can certainly reduce risk, but only if the components of your portfolio make money in different ways or have explicit risk controls. Waiting around for stocks to (hopefully) come back after the next big downturn is probably not going to cut it.