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Financial Briefs

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Managing Investment Risk

Risk — the possibility of losing money — is one of the most feared words in investing. Despite most people's aversion to risk, the history of market manias shows that most people — even some of the most risk-averse — have the ability to abandon their fear of losses when asset prices soar for a long time and everybody else seems to have made a lot of money.

So what gives some people the ability to control their emotions and make cool and calm decisions? Two main reasons are that they know how to measure and how to manage risk. And, to the extent that individual investors learn both, they increase their chances for making smart decisions that keep their portfolios on track toward meeting their goals.

Two Ways of Measuring Risk

Beta — Professionals have two common ways to measure risk. The first is beta, which is how closely a portfolio's performance matches or varies from that of a benchmark index. The benchmark for large-company U.S.-traded stocks is the S&P 500 Index, while a general benchmark for bonds of medium-range maturity is the Barclays Aggregate Bond Index. The performance of indices is normally expressed as a percentage and reflects their total return, which is a combination of any interest or dividend payments and their change in price.

Beta is expressed as a number on an open-ended scale, and it can be a positive number, a negative number, or zero. A beta of 1.0 means that a stock or portfolio's returns are identical in both size and direction to the benchmark, while a beta of -2.0 means that the portfolio's returns are twice as large in the *opposite* direction of the index. For example, when the S&P 500 return is 12%, a portfolio with a beta of 1.0 should also return 12%, while a stock with a beta of -2.0 should lose 24%. A beta of 0.0 means there is no patterned relationship between the two returns.

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10 Common Investor Mistakes

The reason nonprofessional investors often err was well-known even before the new science of investment psychology was born: we're only human, and something happens deep within us when we're handling our own money that doesn't happen when we're handling someone else's money. When it's our own, it's the vehicle for realizing our dreams and warding off our waking nightmares, and every decision we could make looms larger than life.

Here are 10 of the most common mistakes individual investors make while trying to do the best they can:

- **Falling in love with a stock.** There are a host of reasons for this, among them being we or a relative worked for the company, we inherited it, we like being associated with the company's prestige, or simply that it's been a steady performer for as long as we've owned it. The problem is, however, that the stock won't fall in love with us and won't think twice about losing half or more of its value. This is a case where love makes us blind to deep flaws in a company that may never be repaired.
- **Catching a falling knife.** When a high-flying stock goes bad, it drops fast and hard. But when it does, there are thousands of investors who think it's a steal and buy shares when they see it bounce. What they often learn is that they caught the stock in midfall, and like a knife passing right through the palms of their hands, the stock price has a lot farther to fall before finally coming to rest.

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Managing Investment

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Standard deviation — A second way professionals measure investment risk is with standard deviation. Expressed as a percentage, it reflects a range of returns above and below an annual average rate of return for the stock or portfolio itself without reference to a benchmark. It's standard deviation that measures the way many define risk: volatility.

In statistics, when applied to investment returns, one standard deviation covers about two-thirds of all returns. So a portfolio that has an average rate of return of 9% and a standard deviation of 12% means that in six to seven years out of 10, the portfolio's returns range between -3% and 21%. In general, a lower standard deviation is better, because it reflects less chance of a negative return.

Techniques to Manage Risk

Individual investors can use several methods to help reduce the risk and volatility in their portfolios. These include:

- **Diversification.** The fewer number of securities you own in your portfolio, the greater the risk one or more will produce losses that reduce your ability to generate positive compound returns. In a stock portfolio, that means owning stocks of at least 10 different companies from at least five different sectors (such as, but not limited to, technology, consumer staples, finance, energy, and basic materials).
- **Asset allocation.** This refers to spreading your investments over the three classic asset classes (stocks, bonds, and cash) according to a formula that potentially matches the rate of return you need to meet your goals. The formula determines what percentage of your holdings should be from each asset class (e.g., 70% stocks, 25% bonds, and 5% cash). Because bonds and cash generate more steady (but smaller) average returns than stocks, the more of each included in your portfolio, the less volatile your overall returns should be.
- **Dollar cost averaging.** This is a technique that uses price declines to your advantage. It involves making periodic purchases in the same dollar amount of the same securities in good markets and bad. When you continue to buy shares when their prices fall, you buy more shares than when the prices are higher. This gives you more shares, which increases your dollar gains when prices start going back up. However, it neither guarantees a profit nor protects against loss in a prolonged declining market. Because dollar cost averaging involves continuous investment regardless of fluctuating price levels, investors should carefully consider their financial ability to continue investment through periods of low prices.
- **Portfolio rebalancing.** This is a two-step process by which you restore your holdings to the proportions defined by your asset allocation strategy. The first step is to sell a portion of the investments in those asset classes where your holdings have grown to be larger than their prescribed percentage. The second step is to use the sale proceeds to buy more of the securities from those asset classes whose proportions have become too small. This provides a benefit similar to that obtained by dollar cost averaging.

Managing risk isn't about avoiding all losses, since they are an inevitable and normal part of the investment process. Instead, it's about minimizing your losses while achieving the rate of return you need to reach your financial goals.

Please call if you need help aligning your investment strategy with your goals while adapting to changing market trends.

Invest at Your Own Risk

From March 2008 to February 2009, a 100% stock portfolio lost over 43% of its value, and those with a 60% stock portfolio lost a quarter of their value (Source: *Retirement Researcher*, September 22, 2016).

Did you stick to your asset allocation during that time? Many didn't, because they just couldn't stand the extended volatility.

While that was a pretty extreme period of time, the fact of the matter is that your risk tolerance is one of the most important factors in investing. As you probably know, risk tolerance is the amount of risk you're comfortable with taking when investing.

In your portfolio, stocks and bonds play different roles. Stocks are intended to drive the growth of your portfolio and bring the highest return; but without question, they are also riskier.

Bonds tend to be the stability of your portfolio. They may slow down your growth, but they're more dependable and less risky. It is wise to have a combination of stocks and bonds to keep you on track to meet your financial goals. But the real question is, what ratio is right for you?

Think of a 10-point scale, with 10 being the riskiest and 1 being the least risky. You need to make sure you know where you fall on that scale.

For most of us, investing is about meeting long-term financial goals, so making your portfolio match your risk tolerance is key to staying disciplined. When you get your risk tolerance right, you are less likely to bail during market turmoil and should feel more secure with your asset allocation.

That's not to say you should always keep your risk tolerance the same. It's important to think about it at least annually to make sure you are still comfortable with it.

Please call to discuss this in more detail.

10 Common Investor

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- **Investing on tips.** The problem with tips is that the average investor hears them after just about everyone else already has. As a result, we buy the stock at its highest price, and no one wants to buy it to make it go any higher.
- **Chasing performance**. For many people, stocks only get attractive after they've gone so high for so long that they've reached the end of their run. This is also called rear-view mirror investing, meaning you're more concerned with where the stock has been than where it's going.
- **Failing to diversify**. It's smart to spread out your risk, not only among more than one stock, but in more than one industry, sector, country, and asset class. The more diversified you are, the less risk you'll bear.
- **Thinking only short term.** This is actually the opposite of investing. It's speculating. There are few part-timers who succeed at this game. The danger is that just like changing lanes too many times in a traffic jam, you're just as likely to fall behind where you might have been had you just stayed where you were.
- **Playing penny stocks.** Inflation hit true penny stocks years ago. The strict definition is stocks priced less than $5 a share with daily trading volumes of less than 100,000 shares. Usually, the companies have net tangible assets of only a few million dollars and a short operating history. The odds of hitting it big with these are about the same as winning the lottery, if not worse. Owned mostly by individual investors and the founders of the company, penny stocks are notoriously volatile and risky.
- **Waiting to break even.** It's been said that more money has been lost by investors waiting to recoup their initial investments than for any other reason. Successful investors know when it's time to cut their losses and look for a better opportunity.
- **Being too conservative.** This syndrome is the opposite of most of the previous mistakes. In this case, investors are so afraid of losing money that they fail to put enough money in growth vehicles to stay ahead of inflation. As a result, the buying power of their portfolio declines year by year, courting the risk they'll have a lower standard of living the older they get.
- **Investing without a plan.** This is another way of saying all of the above. Sound financial plans match your income, resources, and risk tolerance with an investment strategy providing the discipline that can take emotions out of the equation.

Please call if you'd like help developing an investment strategy.

Does a Buy-and-Hold Strategy Still Make Sense?

If you feel the stock market has been turbulent the last couple of years, you would be right. Consider these facts from the summer of 2014 (Source: InvestingHaven.com, July 2016):

- Crude oil went through its sharpest correction ever, losing more than 70% in 18 months.
- The dollar rally was the sharpest in many decades.
- Stock markets went through three flash-crashes never seen before.
- Many individual stocks lost between 50% and 70% of their value, as stock indexes remained close to all-time highs.

During what we think of as normal times, stocks increase over time with slight market corrections. But in the last few years, central bank policies have disrupted normal market behavior, which has caused some difficult market conditions. Some call it a whole new world of investing. So does a buy-and-hold investment strategy make sense in these times? There are various views on this; but the consensus seems to be that it still works, although you may need to do it differently than in the past.

There are several advantages to buy-and-hold investing:

- Fewer commission because you are not trading as often.
- Tax benefits as the IRS taxes long-term gains at a lower rate.
- People feel less likely to get out of the market during periods of turmoil.
- Not needing to pay attention to the market as much by sticking to the strategy.

The last point is exactly what is different about today's buy-and-hold strategy. You still need to keep an eye on your strategy. The new requirements for a successful buy-and-hold strategy include:

- Only consider buying stock in best-in-class companies with a decent track record for growth.
- Hold a diversified portfolio so you are not subject to the risk of an individual company.
- Be ready to get out of any stock once it falls 10% or more from the price you paid.
- Rebalance your portfolio on a regular basis by scaling back portions of your buy-and-hold portfolio that do better than other parts.
- Get rid of investments that no longer meet your needs. If you put the portfolio together when you were in your thirties and are now in your fifties, your objectives and risk tolerance have probably changed.

At one time you could feel comfortable that your long-term buy-and-hold strategy would be relatively smooth with solid returns. However, the up-and-down market is now taking your portfolio for a bumpy ride that could result in significant losses. The bottom line is that we are in different times, and you have to be diligent about watching your investments.

Business Data

Indicator	Month-end Dec-16	Jan-17	Feb-17	Dec-15	Feb-16
Prime rate	3.75	3.75	3.75	3.50	3.50
3-month T-bill yield	0.56	0.52	0.52	0.26	0.29
10-year T-note yield	2.55	2.43	2.46	2.24	1.78
20-year T-bond yield	2.86	2.74	2.80	2.60	2.19
Dow Jones Corp.	3.17	3.22	3.17	3.43	3.25
GDP (adj. annual rate)#	+1.40	+3.50	+1.90	+1.40	+1.40

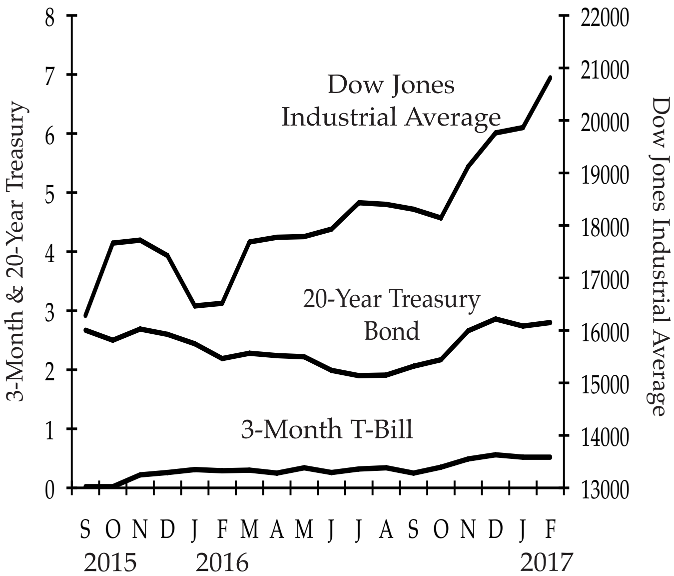
Indicator	Month-end Dec-16	Jan-17	Feb-17	% Change YTD	12-Mon.
Dow Jones Industrials	19762.60	19864.09	20812.24	5.3%	26.0%
Standard & Poor's 500	2238.83	2278.87	2363.64	5.6%	22.3%
Nasdaq Composite	5383.12	5614.79	5825.44	8.2%	27.8%
Gold	1159.10	1212.80	1255.60	8.3%	1.7%
Unemployment rate@	4.60	4.70	4.80	4.3%	-2.0%
Consumer price index@	241.40	241.40	242.80	0.6%	2.5%
Index of leading ind.@	124.00	124.70	125.50	1.2%	1.9%

— 2nd, 3rd, 4th quarter @ — Nov, Dec, Jan Sources: *Barron's, Wall Street Journal*

Past performance is not a guarantee of future results.

18-Month Summary of Dow Jones Industrial Average, 3-Month T-Bill & 20-Year Treasury Bond Yield

September 2015 to February 2017



News and Announcements

Asset Correlation: What Is It and How Do You Use It?

Asset correlation is the measure of how assets move in correlation to one another. Highly correlated assets move in the same direction at the same time, while negatively correlated assets move in the opposite direction from one another — one moves up as the other moves down.

The theory of asset correlation is that you can reduce risk and increase returns by investing in asset combinations that are not correlated. The basic rule has been that equities go up when economies perform better, and bonds perform better when economies go down. Their low correlation to one another is why this has been effective over the years.

Having a mix of bonds and stocks in portfolios has always been a basic investing concept; but today's market is not as predictable or stable, and the way they move is changing. Recently, bond markets have become more highly correlated to equities.

This change in correlation has become a new risk factor investors need to think about when developing their asset allocations. It's not just about the percentage of bonds in your portfolio anymore, but the types of bonds as well. The new thinking is that you have to plan your investment strategy around volatility because of the change in bond behavior.

Diversification Is Still the Key

With correlations increasing among equity classes, investors need to be diligent about their portfolio strategies to ensure sufficient diversification. You may want to do some research on your portfolio to see how your asset correlation has shifted over time, so you can focus your rebalancing efforts on these fluctuations.

The bottom line is that traditional asset allocation must be done in a smarter way to reduce risk and increase returns in your portfolio. Please call if you'd like to discuss asset correlation in more detail.

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