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"There are old investors, and there are bold investors, but there are no old bold investors" —*Howard Marks, from "The Most Important Thing"*

To our clients and friends:

The above quote is taken from legendary investment guru, Howard Marks. The full title of his book is: *"The Most Important Thing: Uncommon Sense for the Thoughtful Investor"*. The message he sends is that investors who are truly successful prioritize the importance of addressing investment risk head-on. In designing a portfolio, they diversify their investments well. They often emphasize a "value investing" orientation.

We all know "investors" you meet at a cocktail party who ignore downside risk entirely. They may even act recklessly. Some of them stick their *entire* portfolio into a single stock, hoping to hit the lottery. Then when the market heads south, taking virtually every stock down with it, they wonder why the market has treated them so badly.

Diversification is the Key

We, as investors, have much to gain by diversifying as broadly as possible. Reducing the percentage of equities (stocks) in one's portfolio naturally reduces one's equity risk. For most investors, monitoring the level of equity, or risk, investments is critical. Keeping the risk level within one's own personal comfort zone helps avoid making mistakes based on emotion. These emotional mistakes are what cause investors to dramatically underperform not just the market, but also their stated investment objectives.

Trying to combine various asset classes into one's portfolio is sometimes difficult. It also takes discipline. Market research suggests that broadening a mix of core assets is the best way to guard against excessive volatility and address risk. In a perfect world, your portfolio would contain at least one investment that responds positively to every potential market scenario. It is the *management* of these relative allocations to each market scenario that permits the greatest opportunity to add value to a portfolio.

Keeping it Balanced

The definition of a "conservative" investor is one who is seeking the best possible rate of return with the lowest possible risk. It bears noting, of course, that *high* investment returns cannot be earned without taking *substantial* risk. "Safer" investments, on the other hand, will produce lower returns, but will do so with a bit less volatility. As stated earlier, a portfolio's risk is directly related to the percentage of equities in the portfolio.

A true “balanced” investment strategy has 50% in equities (stocks) and 50% in fixed income investments like bonds and cash. A balanced strategy achieves its objective through both capital appreciation (via equities) and the production of income (via bonds).

As I’ve stated many times, if you have 100% of your money in a stock index like the S&P 500 or Wilshire 5000, you are, by definition, always fully invested in stocks. This means that you will be exposed completely to the high levels of volatility (and risk) that will inevitably occur.

In a truly balanced account, one is *never even close* to a 100% invested stock or equity position. The volatility and risk levels will therefore be lowered considerably. If you are a risk-averse investor, you will sleep well at night. It all comes down to *risk* versus *return.*

A balanced strategy is appropriate for any investor—regardless of age—who has demonstrated a lower tolerance for taking risk. Investing, by definition, requires a 3 to 5 year investment horizon. Given that time frame, the balanced approach is expected to achieve a higher rate of return than cash or other fixed income holdings. The caveat, of course, is that the balanced portfolio will fluctuate in value, and losses may be sustained.

Age vs. Risk

Understanding your risk tolerance is a critical factor in determining your asset allocation. Many advisors recommend allocating one’s assets based on age. It is certainly arguable that the older you are the less money you should have in stocks and equity-type investments, and the younger you are, the more money you should allocate to those same investments.

But the decision to select a balanced approach to investing (as discussed earlier) should be based on your risk tolerance and not on your age. Not all young people are risk-takers or aggressive growth investors. Not all older clients are risk-averse, either.

The balanced approach should be embraced by investors whose investment objective is moderate growth without excessive volatility or risk being taken. A balanced approach is *not* one which is over-weighted in stocks or stock mutual funds. It is also not appropriate for the aggressive growth investor. And age is not necessarily a key factor.

<u>Addressing the Psychology of Volatility</u>

Questions you should ask include: How much risk am I willing to take? What kind of portfolio swings can I withstand? For a *long-term* diversified portfolio, the one idea that all investors should adopt is to think very carefully about risk. We should plan to manage risk actively. That means thinking about broad diversification and broader asset classes, if necessary.

Volatility is triggered by real events. One of the biggest issues hanging over the markets today is geopolitical instability and the threat of terrorism.

Although volatility will be reasonably low during periods of calm, after any kind of political change or significant geopolitical event, we see volatility spike tremendously. Excessive volatility feels like a roller coaster ride. Investors need to know what this means to their investment portfolios and how to handle it emotionally.

Periods of sharp volatility never seem to become easier to accept, even after having lived through the experience of late 2008 and early 2009. We all know we should stay focused on the long term. But we also know how difficult that can be in tumultuous times such as we experienced during the summer months of 2010 and 2011.

During periods of sharp volatility, the allure of the “sidelines” can be very strong. But when volatility does occur, you should ask yourself whether the information you’re seeing or hearing on television and in the financial news accurately reflects your own individual financial situation.

Are the reports being broadcast really a measure of ***your*** portfolio? Isn’t it true, in fact, that it’s what ***your*** portfolio is doing, as opposed to what the “market” is doing, that truly matters? Often, the media hype is referred to by the smart money as a lot of “noise”. That noise can be a serious distraction to any investor with a longer time horizon.

The number one question on every investor’s mind during sharp periods of volatility is” *What should I do now, if anything*”? It is always wise—imperative, in fact—to take a step back and put the markets’ chaotic behavior into a broader context.

The lesson: We need to be aware of how our portfolio may change over time and during varied market conditions. This awareness requires a thought process that should occur right now, while markets are at high levels. It should *not* occur after a disaster hits. By then, we may all be panicking. Thinking about it now, while we are relatively calm, allows us to visualize in advance what kind of consequences we can or cannot tolerate.

<u>Risk Allocation—Avoiding Uncertainty</u>

Thus, we need to manage our *risk* allocation just as much as our *asset* allocation. Investors generally respond to changes in risk. Many investors are willing to take risk—what they *aren’t* willing to do is to be uncertain about their risks. So the first new rule is that we have to be more active in managing our risks and being fully aware of those risks.

If you take a particular kind of risk in which you expect 10% swings in your portfolio over the course of a year, you're not going to want to see 30% swings. The idea behind risk allocation is to *reduce the surprises in risk*—if you think you signed up for 10% swings, you need to be given 10% swings. There are ways to manage your portfolio to be sure the desired outcome is more likely to occur.

Markets are not all that stable. They can change at the drop of a hat. So we have to be more active about managing our risks. In the old days of the 60/40 portfolio (60% stocks/40% bonds), you could expect a certain level of volatility. This was perhaps 10-20% per year up or down, but now, after 2002 and 2008, that same portfolio can have swings of 30-40% up or down. Most investors never signed up for these kinds of swings.

The problem is that when market conditions change abruptly, people react in a fairly predictable way. When there's a fire, people will run out of a room. And when there are investment losses, people will sell their financial assets and seek safer ground.

As we all know, fear and greed are dangerous emotions which will derail your best-laid investment plans. That is, unless you take the time to deliberate on your goals and risk tolerance. Having the proper risk allocation at the outset will alleviate this danger before it ever comes to pass. This makes the decision to "stay put" much easier.

Conclusion

If anyone reading this newsletter does not have an investment manager who is verbalizing—in a fairly loud voice—the issues raised here then you may be subjecting yourself to unknown risks. I continue to see portfolios (none of which belong to my clients) that hold excessively volatile or unduly risky investments. More often than not, the account holder is unaware of the level of risk that is being taken. This is a major "red flag". It will eventually result in emotional distress. And it can lead to a potentially disastrous outcome.

My suggestion: Reassess how your portfolio might be affected by the market's gyrations. If necessary, make adjustments in order to maintain a well-diversified portfolio—one designed to help reach *your own* ***individualized*** investment and financial goals. A great investment manager should be able to offer you a variety of techniques to cope with market volatility as well. They should communicate those to you at all times.

Thank you for your continued interest.

Sincerely,

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