GLOBAL FOCUS CAPITAL LLC
INSIGHT THAT MATTERS

Worried About Your Investments?

Three Things You Can Do To Lessen Your Fears

After the harrowing experience of the 2008 Financial Crisis investors have acquired a heightened sensitivity to market dips. While global economies have for the most part recovered, trouble spots still loom on the horizon and global macro-economic conditions remain frail in the eyes of most investors. Investors have benefitted from the recovery of equity and fixed income markets, but market participants now fret about over-valued conditions and a lack of yield.

In general, on the surface there is an uneasy sense of calm prevailing in the markets, but anecdotal evidence points to a general climate of investor nervousness.

While the timing and severity of market meltdowns is impossible to forecast with any reasonable degree of accuracy, investor can take action to better prepare themselves for the inevitable turbulence ahead.

One option is to Review Your Strategic Asset Allocation Plan: The first and most important action that investors can take is to thoroughly evaluate their total investment portfolio in relation to their goals and risk appetite. Large institutional investors such as pension plans regularly conduct strategic asset allocation reviews that determine broad asset class exposures and appropriate risk levels in relation to a plan's stated goals and ability to withstand capital market shocks.

Individual investors are no different from large institutions in the need to regularly assess if their portfolios are structured in a manner consistent with their current goals and their stomach for sudden losses in capital. As Yogi Berra once said "if you don't know where you are going, you will end someplace else".

Knowing what you want and how much pain you are willing to incur is the starting point for structuring an investment program that removes worry and deals with what is in your control. The day to day vicissitudes of the capital markets are beyond anybody's control so action item one is to strategically look at your portfolio for its fit with your goals and willingness to tolerate capital losses. If there is a good fit you have done everything within your control.

In the short term, nothing guarantees against disappointing outcomes, but over the long-term capital markets tend to exhibit certain tendencies such as stocks outperforming bonds but with more interim volatility, credit strategies outperforming government bonds again with more volatility, and money market investments being the safest but lowest yielding asset class. A well designed strategic plan should allow the investor to lessen their fears and only make adjustment as circumstances change.

Another course of action is to Buy Protection on Your Portfolio: Just like people buy insurance policies to protect them financially against adverse events such as a house fire, a flood or the death of a parent, investors can structure an insurance plan covering their portfolio. There are many different flavors of insurance available to investors. The type of insurance strategies most commonly used by investors are not contractual in nature and thus do not guarantee a firm floor for the losses. Instead strategies are designed to "hedge" against severe negative portfolio outcomes on a best efforts basis.

The specific features of the hedging program involve determining the potential maximum expected loss (think deductible), the assets covered, length of coverage, hedging tools employed, and finally the expected cost of the program. Barring highly unusual capital market conditions, portfolio insurance programs involve a cost to the investor (think premium).

Typical hedging vehicles include exchange traded derivatives on indices. The strategies could involve buying a put option on the S&P 500 to protect against major adverse equity market developments, or shorting a T-Note futures contract to offset the harmful effects of interest rate increases on a portfolio. The specific strategy would optimally be calibrated to the investor's portfolio, but in recent years we have seen the issuance of several inverse ETF's (see PSQ) and rules-based products (see PHDG) designed to provide generic hedging capabilities.

In all cases, the assumption is that there is a negative correlation between the performance of the hedging strategy and the portfolio one is trying to protect. When the portfolio takes a hit the idea is that the losses would be partially offset by gains on the hedging vehicle. Portfolio protection programs typically come at a cost and the quality of the protection is highly dependent on the structure of the program and the degree of customization involved.

Finally, Use a Tactical Asset Allocation (TAA) Overlay. Such an approach is predicated on the ability to identify periods of time when capital markets relationships appear distorted. The approach involves removing exposure to certain asset classes (the menu typically involves stocks, bonds, cash, real estate, commodities and alternatives) when the likely profits are minimal in relation to the risk taken, and

conversely adding exposure to asset categories when, for some reason or another, the risk of doing so is low in relation to the potential reward.

The trigger in most TAA programs for making portfolio shifts are changing expectations for asset class returns. In addition, shifts may also be driven by the changing risk profile of the asset classes as well as the overall risk aversion of capital market participants.

TAA provides portfolio protection by skillfully adjusting the exposures of asset classes in the investor's portfolio. Typically, TAA programs work in conjunction with the longer-term plan of the investor by incorporating measured deviations from the set of exposures prescribed by the strategic plan. The TAA program will, in theory, dampen the short term downside volatility of the overall portfolio while still allowing the investor to enjoy the long-term rewards of the strategic plan.

TAA is a skill-based active approach to portfolio management and as such can offer the dual benefits of enhanced returns (due to the tactical shifts) and lower interim portfolio volatility, but in the absence of skill there will be a cost associated with the activity. Sometimes the cost will be in terms of missing out on unusually positive returns (if the TAA strategy is positioned too defensively) and at other times the cost will come from incorrectly tilting the portfolio toward asset categories with disappointing performance.

"Thinking will not overcome fear but action will" as W. Clement Stone once said. All three action steps mentioned above will lessen your fears, but the greatest contribution to your financial well-being is forming a strategic asset allocation plan.

Examining your goals and willingness to take risk and structuring your portfolio accordingly is the key action step that will allow you to more confidently navigate through the inevitable market ups and downs. A solid risk management approach to investing and a tactical ability to adjust to temporary capital market dislocations will enhance only enhance the hard work of planning ahead.

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