Disaster Avoidance – It's No Accident

The title of this article could be said to be true generally in life but is especially true in terms of investing. Our firm's constant goal is to grow our client's capital while seeking to avoid disaster in the markets. As the title says, that is no accident and no time in the markets could be more telling of this risk than where we are now. Indices are consistently setting new records, investor exuberance is high and risk management largely gets ignored as the lemmings chase ever higher returns to their ultimate demise. Don't get me wrong, we are enjoying the successes of this run as well but not to the fault of ignoring risk. No one knows the date but believe me, this party will end and when it does it will most likely be incredibly painful to many. This is not being pessimistic it's just not being ignorant of and refusing to acknowledge history.

Benjamin Graham, the "Dean of Wall Street" and from whom Warren Buffet has said he learned all he knows about investing, said that "The essence of investment management is the management of risk, not the management of returns". If this is true (and it is) then what's to be done.

The investment industry's standard method of managing risk in a client portfolio is best exemplified by the widely used "60/40 portfolio". The "risk management" is the 40% held in bonds which are meant to act as a buffer to stocks during bear markets since they tend to be favored in times of stock distress. This has become so standardized that it is commonly referred to as simply the "balanced portfolio". In fact, throw a dart at the mutual fund's page of the Sunday paper and you'll probably find one of these funds. At best, if you're with a traditional advisor, you may find a bevy of bond and equity mutual funds blended together in a format representing the same goal, managing risk by balancing bonds to equities. This passive, fixed and unchanging style of risk management is called Static risk management. But, does this Static method provide the desire of risk management most people desire. The answer is NO! It typically supplies too little protection in the bear markets and too much in the bull markets. In fact, you could think of a static portfolio of as being dressed for all types of weather conditions but being prepared for none (like wearing your ski parka and beanie cap while walking around in your Bermuda shorts and flip-flops – I've illustrated him here for your viewing pleasure).

We believe the disciplined and structured methodology of Dynamic Risk Management is the better answer to managing risk. Simply put, it is applying quantitative, fact-based assessments of three market time frames to determine overall market health and seek to identify the conditions at which more or less risk management should be applied to a portfolio. Imagine that, actively managing risk. The time frames are represented as Short-term (weeks-to- months), Intermediate-term (quarter-by-quarter) and Long-term (months-to-years). The sum of the time frames determines a market condition reading ranking the broad market as either positive, neutral or negative. As seen in the graphic, knowing what type of market you're in is helpful in knowing how to manage risk in your portfolio. Look at how many days were either neutral or positive versus negative. Yet, look at the dramatic difference in return and total draw-down (volatility from top to bottom) in those time-frames. Market conditions and knowing the strategies that tend to work better or worse with those conditions is helpful in managing risk long-term, especially downside risk. This doesn't ignore the importance of diversification and seeking to be in the areas of the market that show the best potential for return, bonds included, it simply enhances it.

John Templeton's maxim that "bull markets are born on pessimism, grown on skepticism, mature on optimism, and die on euphoria" is, I believe, playing out before us. How do you want to be prepared for the inevitable? Remember, avoiding it is no accident and you have been informed and warned. Let us show what we believe is a better way. We stand ready to help in any way we can. Blessings to you and yours until next time.

Number of Positive Time Frames	Market Condition	Total Days	Percent Total Days	S&P 500* CAGR percent per year	Maximum Drawdown**
0	NEGATIVE	307	8%	-49.1%	-61.8%
1 or 2	NEUTRAL	1913	45%	1.5%	-36.7%
3	POSITIVE	1995	47%	17.9%	-10.2%
	TOTAL	4215			

S&P 500* Annual Return and Drawdown by Market Condition
January 1, 2001 through September 30, 2017

*The S&P is an unmanaged market capitalization-weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent U.S. equity performance. One cannot invest directly in an index. CAGR = Compound Annual Growth Rate.
**Maximum Drawdown is the maximum loss from a peak to a trough of a portfolio, before a new peak is attained. Past performance is no guarantee of future results.

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