



WELCH HORNSBY
INVESTMENT ADVISORS

Risky Business

SUMMARY POINT

Three portfolio risk management structures we believe will be critical to future investment success:

- Create/Maintain a Dynamic Liquidity Framework
- Target an Understandable Return Profile
- Exposure to Non-Correlated Strategies

The past ten years have been extraordinarily challenging for investors. Investors have endured two of the worst bear markets in history, rapid changes in monetary policy, a real estate boom/bust, a subprime debt crisis and one of the most heinous terrorist attacks in U.S. history. The cumulative impact has been a stock market with many zigs/zags yet minimal net gains.



My best definition of risk is more things **can** happen than **will** happen. Despite a lost decade for stock investors, the investing landscape remains exceedingly uncertain. Global debt concerns, the lack of sustained economic growth and inflation/deflation fears collectively contribute to a future where the range of things that **can** happen is probably as wide as it has ever been. Mohamed El-Erian states in his book When Markets Collide, “Investors are well advised to assume greater responsibility for risk management in today’s world where the conditions of yesterday are colliding with those of tomorrow.”

How do we begin to construct a portfolio in the face of what could be an exceptionally risky/uncertain period? In his book Against the Gods, Peter Bernstein states, “The essence of risk management lies in maximizing the areas where we have some control over the outcome while minimizing the areas where we have absolutely no control over the outcome....” Albeit most of our risk management discussions/decisions are very specific to each individual, there are some broad-based portfolio level risk management structures we believe will be critical for future success.

CREATE/MAINTAIN A DYNAMIC LIQUIDITY FRAMEWORK

CASH MANAGEMENT



The first step of an investor’s liquidity framework should identify known short-term withdrawals from the portfolio and create a funding plan to meet those demands. This partial liability matching approach aids in minimizing the risk of negative compounding where investors are withdrawing monies from risk-based asset classes at inopportune times or depressed levels, thus foregoing any recovery that may take place within those areas of the market. As the plan matures, this bucket will be periodically refilled when markets provide attractive exit opportunities and future liabilities become more transparent. The comfort in knowing a plan has been established to fund short-term liquidity needs allow investors to take a longer-term view with the remaining portion of their portfolio.

LOW VOLATILITY



The low volatility component of the portfolio attempts to manage both risk and uncertainty by dampening the portfolio's overall volatility, providing partial insulation against some forms of market trauma and offering a second source of liquidity to shield the portfolio from sudden unexpected demands on the portfolio.

CAPITAL APPRECIATION



The primary objective of the capital appreciation component of the portfolio is growth, aiming to manage the ultimate long-term uncertainty – *Will I be able to provide all of the resources required to fund all future outlays?* In most cases, we believe this structuring of liquidity enables clients to employ more strategies within the capital appreciation component of the portfolio including less liquid opportunities that may offer attractive illiquidity premiums and/or desirable diversification benefits.

The size, strategies and allocations within the capital appreciation component drives our second risk management structure.

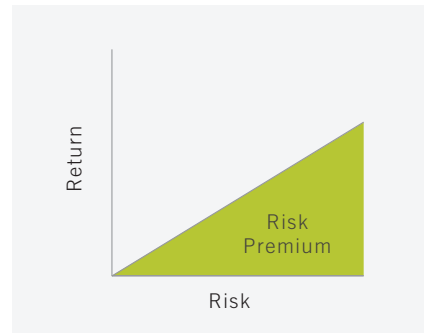
TARGET AN UNDERSTANDABLE RETURN PROFILE

In the current environment where the risk-free rate is essentially zero, investors needing any return from their portfolio must accept risk and rely on the risk premium to provide the necessary portfolio growth.

Typical Capital Market Line Illustration

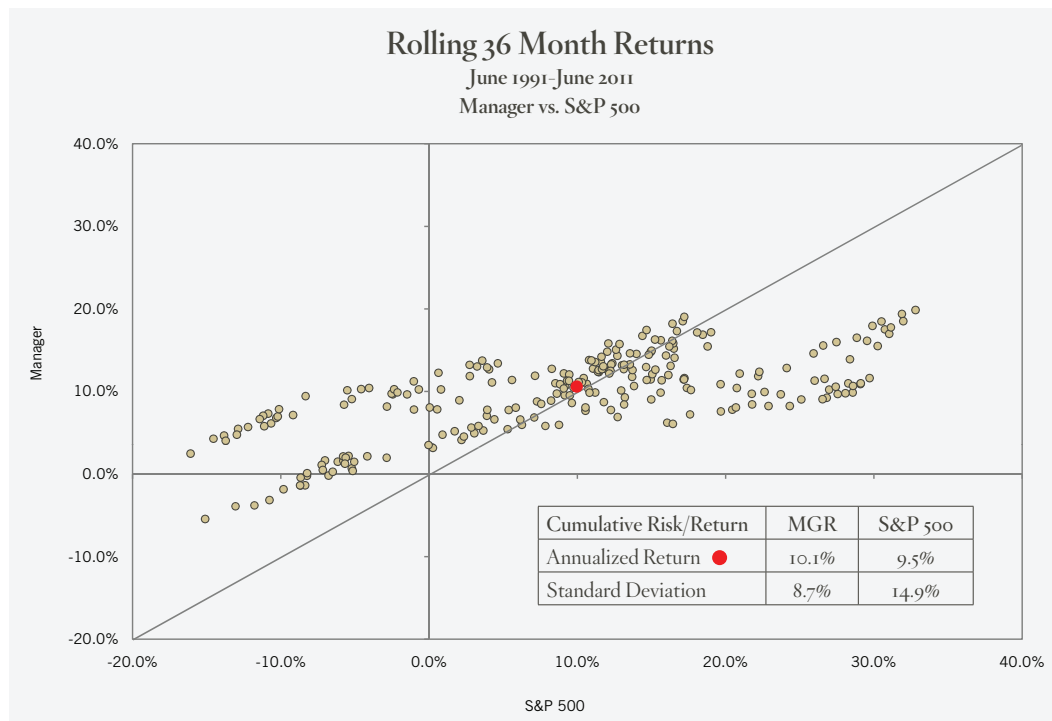


0% Risk Free Return



With risk comes uncertainty decreasing our control over future outcomes. While market movements are outside of our control, we think we have some influence, through our implementation decisions, over how our portfolios react to those movements. We attempt to tilt our implementation efforts toward playing sound defense, believing the creation of long-term wealth can more reliably be achieved by limiting significant losses, in lieu of reaching for outsized returns. This is especially true within portfolios that have periodic distributions.

While there can be no assurances we will achieve it, the following chart illustrates the type of return profile we strive to generate in portfolios. The data reflects actual rolling thirty-six month returns for a sample manager (y-axis) versus the corresponding thirty-six month return for the S&P 500 (x-axis).



We are willing to give up some of the upside market performance (illustrated when the dots fall below the diagonal line) in order to gain some additional protection in difficult markets environments (illustrated when the dots are above the diagonal line). Ultimately, if we can deliver good absolute returns in good markets and great relative returns in poor markets, our clients can achieve superior risk-adjusted results and more efficiently compound their wealth. In order to achieve the desired return profile we often incorporate our final risk management structure.

EXPOSURE TO NON-CORRELATED STRATEGIES

I am reasonably confident everyone has some knowledge of the importance of diversification - it just makes sense not to put all your eggs in one basket. However, the math behind diversification further defines the potential benefits. Consider the following portfolio example:

Two Investments	Expected Return	Expected Volatility	Portfolio Weighting
Investment A	10%	15%	50%
Investment B	10%	15%	50%

In portfolio construction, returns are additive, meaning the expected return on the hypothetical portfolio above would be 10%.

$$[(R_A \times W_A) + (R_B \times W_B)] = R_P$$

R_A = Expected Return for Investment A

W_A = Weighting to Investment A

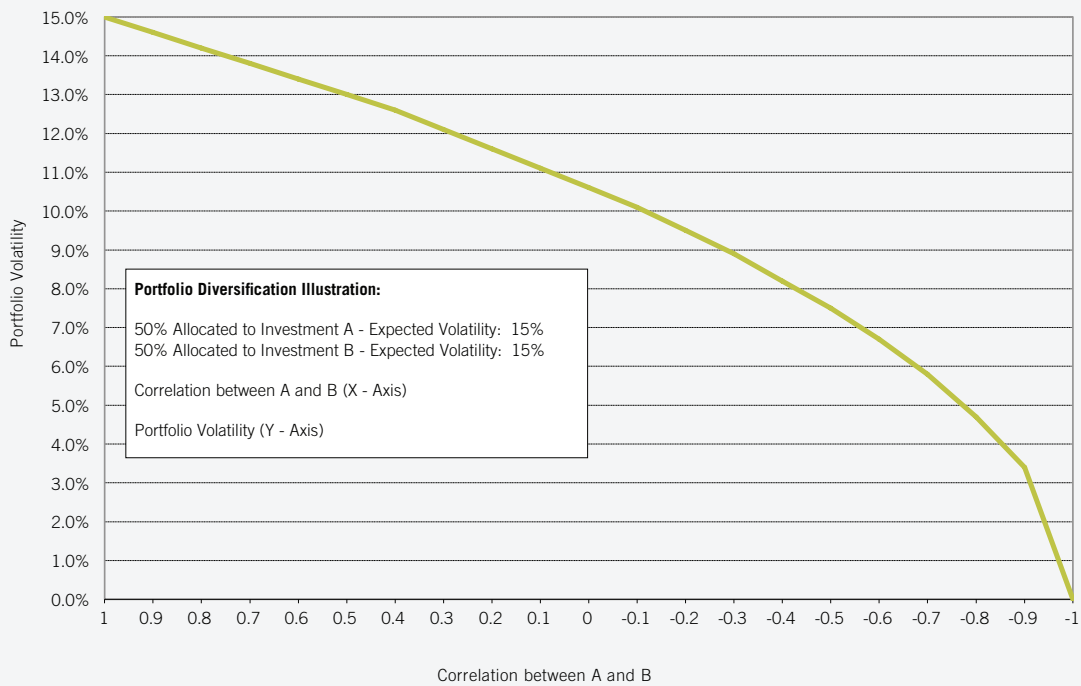
R_B = Expected Return for Investment B

W_B = Weighting to Investment B

R_P = Expected Return for Portfolio

However, unlike returns, risks are not additive unless the investments are perfectly correlated. The following graph illustrates the relationship between correlation and volatility, showing as the correlation between investments A and B declines (x-axis), overall portfolio volatility falls (y-axis).

Risks are not Additive Portfolio Diversification Illustration



Historically, the diversification investment within most portfolios has been in companies domiciled outside the U.S. However, as markets have become more global in nature and the U.S. economy has been viewed as the safe haven and growth engine for the global economy, the diversification benefits have been consistently declining as correlations have increased. The following chart reflects the steadily climbing link between the U.S. and other developed countries by plotting the rolling five-year correlation between the S&P 500 and the MSCI EAFE Index:

Rolling Five Year Correlation MSCI EAFE Index versus S&P 500



When building portfolios, our goal is to determine what the primary return driver will be within each segment of the portfolio. We believe the typical portfolio has an overweight exposure to market risk, relying on equity markets to generate most of their required growth. We seek to identify strategies whose success is less dependent on the stock market moving higher, essentially substituting another form of risk for market risk. These risks may include manager/skill risk (flexible mandates, long/short investing, concentrated stock portfolios), event risk (merger arbitrage, distressed investing, special situations), satellite asset class risk (commodities, real estate, emerging market debt/equity) and/or Illiquidity risk (private equity). The goal is to uncover strategies that derive their returns in fundamentally dissimilar ways in order to benefit from the “free lunch” of diversification.

Some situations can lead us to areas outside “traditional” publicly traded vehicles, into private funds or limited partnerships (when appropriate). We see a “hedge fund” or a “private equity fund” as an investment structure **not** an investment strategy. As previously discussed, we work to understand the functional attributes of an investment with the legal and structural issues addressed during the implementation phase. While the firm does utilize certain strategies, we have a few overriding principles when considering an investment in either public or private funds. (1) We must understand how each strategy makes money and feel confident we can educate a client as to how the investment will work. (2) We utilize fundamental-based strategies. Far too often, investors replace fundamental analysis with probability analysis and apply leverage creating an “event risk” that cannot be quantified. (3) We avoid highly leveraged strategies, understanding leverage only magnifies the risk of an investment. (4) We want to understand how the investment should react in various market environments to better understand its impact to the overall return profile.

While we recognize risk has a different definition for nearly every investor and work extensively throughout the relationship to ensure portfolios are customized based on each investor’s risk views/tolerances, we believe the three portfolio-level risk management structures discussed are essential components of the core building blocks for future investment success.

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