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SIGMA INVESTMENT COUNSELORS

the official newsletter of sigma investment counselors March 2016

Revisiting Risk Tolerance

Risk tolerance is defined as the degree of variability in investment returns that an investor is willing and able to withstand. It is impossible to generate meaningful long-term positive investment returns without taking some risk. As a result, risk tolerance is one of the most important components of the portfolio management process. At the same time, accurately measuring risk tolerance is extremely difficult.

March 9th of this year marked the seventh anniversary of the 2009 equity market bottom. For many investors, the sting of the worst recession since the Great Depression is still fresh in their minds.

From October 9, 2007 through March 9, 2009, the total return of the S&P 500 Index was -43%. That same index has subsequently recovered all of its 2007-2009 losses and then some, exhibiting a total return of 245% since the market lows of March 9, 2009.

At Sigma, we've heard stories of many investors who sold out of the market at or near the lows of 2009, never got back in, and missed most or all of the subsequent recovery in stock prices. These are investors who may not have accurately assessed their own tolerance for risk (whether on their own or with their advisor). On the other hand, investors who had a portfolio structure and long-term plan that accurately reflected their tolerance for risk were in a much better position to 'ride out the storm', and in many cases, advantageously rebalance into the equity market weakness.

At Sigma, we spend a lot of time trying to establish what each client's true overall tolerance for risk is. This can be especially difficult for clients who have not yet experienced a market correction under Sigma's management.

The first quarter of 2016 has given many investors an ideal opportunity to review their risk tolerance. The S&P 500 had a 10%+ correction in January and February, followed by a sharp recovery in March. At the time of this writing, the S&P 500 is essentially flat for the year. While the timing, size, and duration of corrections are unpredictable, they are a normal market occurrence. Ultimately, the manner in which investors migrate through periods of volatility has a meaningful impact on the success of their long-term financial plan. As a result, it is imperative for investors to consider how much volatility they are both willing and able to handle.

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There are a few questions that can be helpful when attempting to make sure that a client's portfolio is structured appropriately in terms of risk tolerance.

Do emergency reserves exist outside of the portfolio?

Emergency reserves should always be in place to serve as the first line of defense. Generally, we like to see clients carry 6-12 months of living expenses in the bank. For clients who have higher cash balances at the bank, there is an ability to be a bit more aggressive in the portfolio. For clients who carry minimal cash balances at the bank, the portfolio should be positioned a bit more conservatively.

How many years of liquidity should exist in non-stock holdings?

Once 6-12 months of emergency reserves are set aside in cash, it can be helpful to consider how much of the portfolio should be invested in relatively safe, non-equity investments. Typically, non-equity investments consist of high quality, investment grade bonds. While there is no hard and fast rule, I personally like to know that a portfolio could support planned distributions for the better part of a decade without ever having to liquidate stocks in a down market. This means having enough dividend and interest income, along with safe, non-equity holdings to ensure that cash will be available when it is needed.

Generally, if an investor can avoid ever having to be a forced seller of equities at depressed prices, they materially increase the probability of success of their overall plan. Having sufficient balances in non-equity investments is one way to avoid selling equities at depressed prices.

When will you need support from the portfolio?

For clients that are still in the accumulation phase of their plan (i.e. still working and/or not taking distributions), it is important to establish an expectation of when support from the portfolio will commence. When required support is 10 or more years away, an ability to tolerate higher levels of volatility exists. As anticipated distributions appear on the horizon, a gradual reduction in the overall allocation to equities tends to take place.

How would you feel if the value of your portfolio went to $X?

Sometimes clients have a plan that is able to tolerate volatility, but their own willingness to tolerate volatility is substantially lower. In this case the conservative nature of the client's willingness to tolerate volatility trumps the ability of their plan to tolerate volatility. I will oftentimes ask a client what their ultimate pain point in terms of portfolio value is. This is probably the most honest way to assess one's willingness to take risk, outside of actually going through a bear market.
If a client has a $1,000,000 portfolio and they admit that they couldn't possibly fathom having

to watch it go to $750,000 in a bear market, then it is up to the advisor to structure the portfolio accordingly. It is almost always prudent to err on the side of being conservative, so as to avoid emotion-driven selling in an equity market pullback.

Will the structure of the portfolio allow for unemotional rebalancing at the appropriate time?

Believe it or not, sometimes volatility can be a good thing. First, it can keep the overall market from becoming overly exuberant. Second, it can create opportunity for those who are prepared. For most Sigma clients, that opportunity consists of being able to rebalance; trimming portfolio positions that have gotten overvalued on the upside, and adding to positions that appear to be undervalued on the downside. Put simply, in a significant pullback, would the structure of the portfolio allow you sell some of your safe bonds in order to be a buyer of equities? Clients and advisors who have miscalculated risk tolerance become so emotional, that their inclination is to sell equities during a pullback. If an investor felt the need to sell equities in January or February of this year, then their portfolio may have been too aggressive.

In sum, it is impossible to generate meaningful long-term positive investment returns without taking some risk. As advisors, it is our job to manage risk, as opposed to avoiding risk. At Sigma, our portfolio managers make a point of establishing an overall risk tolerance for every client. In doing so, the client's ability and willingness to accept portfolio volatility must be taken into consideration. Each client situation is unique, but the five questions listed above can help to drive a meaningful discussion on risk tolerance.

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