

PORTFOLIO STRATEGIES

Learning to Manage the Myriad Risks in Your Portfolio

If recent events have raised your stress levels, now is the time to review your portfolio for any of the potential risks.

BY JOHN DEYSHER, CFA

Many investors review their life, home, auto and health insurance to make sure their risks are covered, often at policy renewal time. Unfortunately, some investors don't fully understand the risks embedded in their portfolios.

This became painfully evident in 2022. After years of abnormally low interest rates, the rapid increase in interest rates has disrupted equity and fixed-income portfolios alike.

Before addressing the management of portfolio risk, it's important to assess how much risk one is willing to take. Younger, unmarried investors may tolerate more risk since they have fewer responsibilities and a longer time frame to overcome any mistakes. Investors with family obligations and future college educations may be willing to take less risk since any significant portfolio loss might jeopardize family dreams and aspirations. Finally, investors approaching retirement will often take minimal risks knowing that once retired, paycheck earnings will disappear. So, it's important to first know where you are on the risk spectrum.

Most investors normally allocate a securities portfolio across three major asset classes:

» Cash and cash equivalents: Including Treasury bills, certificates of deposit (CDs) and money market funds.
» Fixed income: Bonds and notes of various durations, maturities and credit ratings.
» Equities: By market capitalization (large versus small), style (growth versus value), geography, sector, etc.

The mix of each in a portfolio depends on where you are in life and your appetite for risk. So, let's examine the basic risks of each and how an investor might address them.

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Risks of Cash and Cash Equivalents

While this asset class is the most conservative and usually has a minimum risk of loss, there are several risks worth noting.

Bank Risk

While CDs are usually good when insured by the Federal Deposit Insurance Corp. (FDIC), the standard insurance amount is $250,000 per depositor per insured bank. If you exceed this threshold, you might consider diversifying your CDs across multiple financial institutions.

Credit Risk

Money market funds that invest in short-term government and agency securities are safer than those that invest in short-term corporate securities like commercial paper and repurchase agreements. If you want minimal risk at a slightly lower yield, stay with T-bills and government money market funds.

Inflation Risk

There is always the risk that the return earned on short-term, relatively safe cash equivalents may not keep pace with inflation. Present inflation is higher than the returns offered by most cash equivalents, creating a negative yield. Closing the gap may require you to reach for a higher yield in return for a less safe investment, so make sure you understand the risks.

Fixed-Income Risks

Bonds run the gamut from government, agency and municipal securities to investment-grade corporates to high-yield securities. Bond indentures (pay attention to the terms, clauses, covenants and other details) are increasingly complex, so it's important to know what you are buying. Here are some of the primary risks with bonds.

Interest Rate Risk

As we know, bond prices move inversely to interest rates—as rates go up, the market price of bonds declines. The longer the maturity is, the bigger the change in value when rates change. Assuming the bond is issued by the federal government, a government agency (e.g., Fannie Mae, Ginnie Mae and Freddie Mac), or a corporation or municipality with a solid credit rating, the investor who holds the bond to maturity will normally receive par value ($1,000 per bond in the U.S.). An investor who is forced to sell before the maturity date but after rates have risen will normally collect less than the bond's par value.

If you think interest rates will rise, you may want to seek shorter maturities to avoid unwanted erosion of principal. If you think interest rates will fall—because of a slowing economy for example—you may want to lengthen your maturity. If you're unsure where interest rates are headed, you may want to stagger (ladder) your maturities so you have the liquidity of short-term bonds, which will mature sooner, and the income from the higher-yielding long-term bonds.

Credit Risk

This is the possibility that the issuer may not be able to repay principal or interest due to financial distress. While not an issue with government or agency bonds, corporate or municipal issues may be downgraded by rating agencies, causing their values to fall. If you own corporate or muni bonds, it's best to monitor their credit ratings to avoid the unwanted surprise of a ratings downgrade.

Call Risk

This is the chance of a bond being redeemed before maturity. In such cases, the investor won't earn the anticipated rate of return for the full term. If interest rates fall, the issuer will redeem (call) the bond early and refinance it at a lower rate. Should interest rates rise after issuance, the issuer will do nothing since it makes no sense to refinance at a higher rate.

Risks With Equities

While equities have delivered the highest rate of return over the long term, there have been long periods where equities delivered minimal or even negative returns. This often occurs after a long uptrend. Risks worth noting are as follows.

Company-Specific Risk

If profits decline, the balance sheet gets leveraged, important customers are lost, competitors make inroads, key executives leave or another detrimental event occurs, the stock price will normally decline.

Market Risk

When the general market declines, such as occurred between 2007 and 2009 and in early 2020, most stocks will also decline even if individual firms are doing well. In a bear market, virtually all stocks go down.

Macro Risk

This covers the risk of economic factors—including interest rates [which influence price-earnings (P/E) ratios], geopolitical tensions and regional or global health issues—negatively impacting the market and by extension individual stocks.

Liquidity Risk

Generally speaking, larger market-cap firms are more liquid. This makes it easier to buy or sell their stocks without moving the share price very much. Firms with smaller market caps may trade with less volume. If you feel you may need to sell quickly, it's best to stay with larger-cap companies.

New Issue Risk

While every investor dreams of buying the next Apple,

A Summary of Common Risks in Major Asset Classes

Most investors hold a mix of cash, fixed-income and equities in their portfolios. Each of these asset classes faces its own risks.

Cash and Cash Equivalents

- Bank Risk: Exceeding the FDIC limits could be problematic if the bank fails.
- Credit Risk: Money market funds with higher yields are often those investing in riskier debt securities.
- Inflation Risk: Dollars allocated to cash equivalent investments may lose purchasing power over time.

Fixed Income

- Interest Rate Risk: When interest rates rise, bond prices fall.
- Credit Risk: If chance of the bond issuer encountering financial distress.
- Call Risk: The possibility of the bond being called prior to maturity.

Equities

- Company-Specific Risk: Internal problems that cause a firm's stock to fall.
- Market Risk: In a bear market, virtually all stocks go down.
- Macro Risk: Economic changes and other headline events can drive stocks lower.
- Liquidity Risk: The inability to sell a stock quickly.
- New Issue Risk: The risk of shares of a new company falling after the initial public offering (IPO).
- Margin Account Risk: Losses are amplified when money is borrowed to purchase stock.

More Tips for Reducing Equity Risk

There are several ways you can reduce the risk of investing in stocks. Here are the key ones.

Diversification

A fundamental error of many investors is failing to properly diversify. Most of the volatility of a single-stock portfolio comes from the risks associated with the single company. Two or three stocks is better, but it still leaves the investor exposed to the fortunes of those firms. Studies show that basic portfolio diversification should consist of holding 30 to 40 stocks unrelated to one another. Closely related stocks (i.e., a group of homebuilders) should be viewed as a single issue for diversification purposes. If an investor doesn't wish to purchase and monitor 30 to 40 securities, a diversified fund may be a suitable alternative.

Related to diversification is position sizing. Winners are great but not if they cause a portfolio to become overweight in a particular security. At Pinnacle, unless we have extremely high conviction in a company's prospects, we will normally limit its weighting in our portfolios to 5% or 6%. If the stock moves higher, we will pare the position back to limit the damage from any possible disappointment.

Dollar-Cost Average

This is a disciplined investment strategy that helps smooth out the impact of market fluctuations. Using this approach, an investor buys a set dollar amount of a security on a regular basis, $1,000 per month for example. Applied consistently, this results in more shares being purchased when the price is low and fewer shares when the price is high. Over time, the average share cost will be lower than the average market price.

The strategy works because it removes the emotion from the investment decision.

Maintain Sufficient Portfolio Liquidity

This will help prevent a forced sale at unfavorable prices should the need for cash arise. While being fully invested in a rising market is preferable, the opposite is true during a declining market. We find it best to keep some cash on hand to provide buying power when needed during market declines. If you want to be able to sell a security quickly, it's best to stay with larger-cap issues as they are often more liquid.

Make Defensive Moves Before You Need To

One of the trickiest decisions facing an equity investor is when to sell. The old saying of 'letting your profits run' makes sense to a point. Very few investors like selling a winner and paying capital gains taxes. But the alternative of missing a window to sell and watching profits evaporate can be even worse. At Pinnacle, we generally sell when:

- Shares reach our target sell price, which may be adjusted upward over time;
- Fundamentals begin to deteriorate;
- We were wrong in our facts, reasoning or judgment;
- Insider selling picks up significantly; or
- We find a better idea offering more attractive risk-adjusted returns.

Some of our biggest mistakes occurred when we knew a stock was approaching peak valuation but held on, rationalizing that a higher valuation justified the current price. Far too often the opposite is true—in one case, for example, a firm was on the cusp of an earnings disappointment that knocked the shares down. Now we adhere to a strict selling discipline that reduces our exposure over time as valuations and the share price continue rise.

Take a Conservative Approach to Valuation

Focus on absolute rather than relative valuations. By absolute, we mean the nominal valuation metric, such as the price-earnings (P/E) ratio, price-to-book-value (P/B) ratio, or price-to-cash-flow (P/CF) ratio.

Relative valuations can give an investor a false sense of security. For example, a stock may be trading at a price-earnings ratio of 12. This might seem inexpensive in a market trading with a price-earnings ratio of 15, but if the stock normally peaks at a price-earnings ratio of 12 or 13, it may be expensive and time to reduce our exposure.

Invest in Companies With Strong Balance Sheets

A strong balance sheet often allows a firm to survive difficult times. This is especially true for smaller firms that are more vulnerable to economic downturns.

Many years ago, Benjamin Graham described the value investing concept as buying a firm's net working capital (current assets less all liabilities) for fifty cents on the dollar. A firm's plant, property, equipment and other long-term assets as well as the growth they might generate were valued at zero.

In Graham's day, stocks selling at a discount to net working capital were common. Today, if you find a stock trading at a discount to net working capital, there is usually something wrong with it. The company may be losing money or experiencing a significant sales decline, questions may exist about its business viability or major lawsuits may have been filed. However, suitable ideas may exist when a corporate action creates a temporary inefficiency.

Many years ago at Pinnacle, we were able to build a position in a small-cap firm that was spun off from a larger firm. The larger firm's shareholders couldn't be troubled with the spin-off and sold it promptly. This created an opportunity for those like us who knew what the spin-off was really worth. It worked out well.

Microsoft or Netflix on an initial public offering (IPO), new issues can be fraught with risk. Investment bankers help take companies public when investor appetite is robust and the maximum equity capital can be raised. Everyone hopes for a strong aftermarket return, but this doesn't always happen.

Margin Account Risk

This is the risk that an investor who borrows money to buy stocks may be forced to sell those stocks after a decline in value triggers a margin call to bring the account equity to a required level. For a stock bought on margin, profits are magnified when the stock price rises. Losses are magnified when the stock price declines. When interest rates rise, it also becomes more expensive to trade on margin. Generally at Pinnacle, unless we have very high conviction on the outcome of our investment hypothesis, we keep margin to a minimum.

Think Long Term and Prepare for What Can Go Wrong

Wall Street is a place where the patient take from the impatient. While most successful investors monitor quarterly results, rarely are they caught up in short-term thinking. Of course, hiccups are always worth noting, but if the fundamental thesis is still intact, stay with it. Some of the biggest winners in our portfolios went through a few disappointments but ultimately delivered on our investment thesis.

Always assess downside risk before upside potential. What's the risk-reward proposition?

Is there an adequate margin of safety? Stocks often fall more than you think they will, so be ready. Benjamin Graham once said, "In the short run the market is a weighing machine, in the long run it is a voting machine." Investor sentiment can move quickly in both directions.

Finally, during your research, put your knowledge, skills and experience to work and keep your emotions out of the process. Focus on the knowable and important, be skeptical of rosy forecasts and don't be afraid to ask tough questions. Always remember to investigate before you invest.

Conclusion

It's never too soon to think about portfolio risk. After the long period of falling interest rates that boosted the prices of most asset classes, it's easy to have gotten complacent. No one knows what the future holds but if recent events have raised your stress levels, now is the time to review your portfolio for any of the potential risks. If you decide you're taking more risk than you want, perhaps it's time to de-risk your portfolio. ■