

Measuring the True Risk Level of Investments

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Loss Risk vs. Standard Deviation

There are more than 50 different performance and risk measures available to analyze investment portfolios. Over time, standard deviation has become the dominant statistical measure of a portfolio's risk posture. Rarely, however, is standard deviation properly presented to clients as a range of return events for a specified confidence level. This representation exceeds most investor's practical comprehension. A far more understandable risk measure is Loss Risk.

Warren Buffett sums up the issue of Loss Risk well in his two rules of investing: "Rule No.1: Never lose money. Rule No.2: Never forget rule No.1."

(<http://www.brainyquote.com/quotes/quotes/w/warrenbuff149683.html>)

Loss Risk is, literally, the risk of losing a dollar. Loss Risk uses rolling periods (such as a rolling three-year period that includes 2006/2005/2004) to pose the following, key question: How likely am I to lose money in a rolling time period? This tends to be far more helpful in enabling clients to grasp the true extent of their risk exposure versus a statistical range based upon price fluctuations.

Matching Investments to Needs

If your client has a specific funding requirement targeted to a particular time horizon –, say, college or a wealth transfer – Loss Risk indicates the likelihood that a shortfall could occur within that time horizon. In general, Loss Risk expressed in two- or three-year rolling periods would show that a long-term funding need (7 or more years from now) can initially be invested aggressively, because the probability of a loss is low. As the liability marches through time and becomes a short-term funding need, Loss Risk probabilities dictate how the portfolio must shift to forestall the possibility of a shortfall.

Minimizing Losses Is Key For Long-Term Success			
Portfolio Loss	-1.00%	-10.00%	-50.00%
Initial Value	\$1,000,000	\$1,000,000	\$1,000,000
Loss in Dollars	(\$10,000)	(\$100,000)	(\$500,000)
New Value	\$990,000	\$900,000	\$500,000
Loss Recovery Gain	\$10,000	\$100,000	\$500,000
Loss Recovery Return	1.01%	11.11%	100.00%

As the above suggests, Loss Risk requires thinking in terms of specific liabilities that must be paid as they come due. Therefore, knowing the investor's need inventory, measured in dollars, and how those needs map across time, become prerequisites for constructing and maintaining an effective portfolio. This enables portions of the investor's overall portfolio to be dedicated to specific need-funding tasks. (This is the domain of goals-based, liability-driven, or cash flow matching wealth management.)

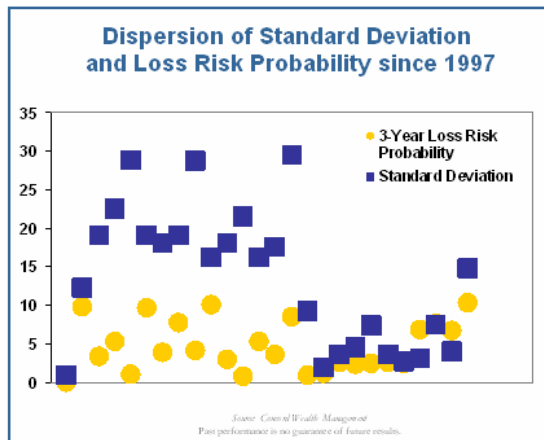
Dollars Lost vs. Dollars Gained

Often lost in performance reporting is an important mathematical fact: For every dollar lost, more than a dollar must be earned to recover the loss. In effect, the power of compounding works against the investor when a dollar is lost. For most clients, minimizing losses is essential for long-term success, as demonstrated in the columns to the left.

The counter holds true, as well: For every dollar that is **not lost**, the portfolio compounds from a higher floor. Consequently, not losing a dollar represents a powerful economic lever. (In the realm of risk analysis, this is captured by the Downside Risk Capture measure.)

How Standard Deviation Can Mislead

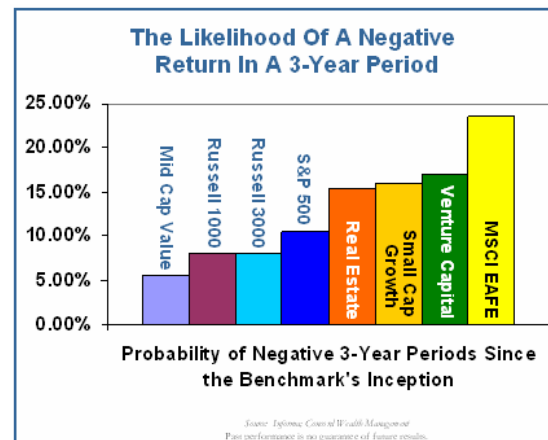
A three-year rolling period for stocks can illustrate how misleading Standard Deviation may be in evaluating risk's practical realities.



As the exhibit to the left demonstrates, the dispersion of Standard Deviation values for 26 traditional and alternative investments across rolling three-year periods from 1997 through 2006 is wide, while the Loss Risk probability dispersion is tight. Loss Risk provides a more realistic picture of how various asset classes actually expose a portfolio to the probability of a loss. In the real world (versus the statistical), bull markets last twice as long as bear markets. Consequently, the majority of year-over-year

returns for an investment with high volatility can reside well in the positive range, thus minimizing the impact of a single down year. (Using rolling periods, the year preceding the loss and/or the year succeeding the loss may counteract the negative result providing a positive Loss Risk for the period.)

We know that Mid-Cap Value stocks for the most recent 5- and 10-year periods have higher volatility than the S&P 500. As a measure of risk, however, that can be misleading. In rolling 3-year periods, Mid-Cap Value has a much lower potential for a negative return than the S&P 500. In rolling three-year periods since 1987, for example, Mid Cap Value stocks have a Loss Risk of just 5.56%, (which also can be stated as a positive return probability of 94.44%), while the S&P 500 has a Loss Risk of 11%.



Freedom to Choose Return

Practically, if two investments have Loss Risk probabilities that are within a liability's funding horizon, then the investor is free to employ the investment with the higher return. Compounded over time, this higher return enhances wealth creation, which provides a cushion to address the difficulty in accurately valuing long-term needs.



The use of Loss Risk has significant asset allocation implications. Investors whose future liabilities extend beyond three years might be prudent to make greater allocations to higher returning asset classes such as Value stocks, Mid Cap and Small Cap stocks and then adjust the portfolio to lower Loss Risk probabilities, as these future liabilities arrive within a three-year funding horizon.

In the end, the advisory community's charge is to provide clients with an understanding of the economic implications of investment decisions. Few clients relate intuitively to statistics, whereas almost everyone has a real world, everyday appreciation of losing a dollar.

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Concord designs, develops, and administers wealth management programs for numerous financial institutions including Trust and Private Banking Firms, independent financial advisors, broker dealers and family offices. Concord's team of experienced financial and technology professionals is frequently called upon to consult on open architecture wealth management platform design elements resulting in customized solutions for the wealth management intermediary. By integrating some of the world's best money managers with the financial institution's existing asset management talent, Concord is able to dramatically expand the firm's asset management capabilities. Thorough manager due diligence, comprehensive portfolio design techniques, trust accounting and custodial interfaces, performance reporting, and numerous analytical tools are delivered to the client via an extremely robust technology platform. Please visit www.concordwealthmanagement.com.

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