Risk Mitigation: 5 Approaches to Mitigate Portfolio Risk.

Abstract

The key to any solid portfolio is the idea of maximizing return while simultaneously minimizing risk. Risk Mitigation is a critical part of managing a portfolio. This paper talks about 5 opportunities where you can reduce risk in your portfolio.

Bob McCarty
rmccarty@warrenfinancial.com

"No risk, no reward."

"That's just a little too risky for me."

"That's a risk I'm willing to take."

"I don't have the stomach for that much risk."

We've all likely heard these clichés, or at least something like them. This 'risk' thing is real and palpable. We worry about it. We lose sleep over it. We second guess ourselves. We take on risk that we're not prepared for and then regret. Risk is real.

Risk, according to the dictionary, is nothing more than exposure to the chance of injury or loss.

All this worry and fuss over exposure to the chance of injury or loss. And chance is nothing more than the possibility or probability of something happening. When something is "possible" that means that it might or could happen, and "probability" is the likelihood that something might happen. In plain English, risk is exposure to the chance that something probably might or might not happen.

I don't mean to minimize the concern about risk, but when tackling a problem, it's always good to have a solid understanding of what the problem might be.

So…if risk is real, what exactly is "it"?

To break it down further, this thing "risk" that you thought was only one thing is made up of three distinct things. Whenever you're concerned about risk, you're concerned with three things – even if you didn't realize it.

We all worry about risk, because at it *the root of risk is fear* – we're afraid of failure, of losing something.

So, ***the first element of risk is the fear of loss.***

Don't get me wrong, loss is a big deal. But as I mentioned a moment ago, risk is concerned with chance…the possibility or probability of failure. If there is a possibility or probability of failure, then it stands to reason that there is also a possibility or probability of success. A rousing success. Or a spectacular failure. Or perhaps, somewhere in between.

"The aggravation that one experiences in losing a sum of money appears to be greater than the pleasure associated with gaining the same amount." (Kahneman & Tversky, 1979)

This second element of risk then, is fear of volatility.

To use the stock market as a practical example, over time, the market has a track record on average, of returning about 10% per year. For the last 100 years! That means, on average, over time, any money invested in the stock market has returned about 10%. Each dollar invested 100 years ago has earned about 10 cents each year. That's great, right? It really is if you take a wide-angle view of the stock market. From the safe distance of time, the returns smooth out to a nice, gentle positive slope of (on average) 10% a year which means that initial one dollar should now be worth nearly fourteen thousand.

But the reality is, there is no smooth, gentle, positive slope to the stock market. Over the last 34 years, the markets have returned anything from a loss of 23% to a gain of 38%, with loss years nearly 20% of the time and gain years about 80% of the time. Those gains have ranged from about 1% to about 38%. So much for a gentle, upward glide…1 out of every 5 years is a loser, and the remaining years are a whipsaw of miniscule to impressive gains.

Risk of loss is bad, and so is risk of volatility.

But there is a third element of risk that's associated with the first two. No one can tell you with any degree of certainty, in fact, no certainty at all, when there will be a failure, nor how spectacular a failure it will be. Remember, when we consider risk, we're talking only about the chance of something failing. Failure or success is rarely a 'sure thing'. Robert Kennedy once said, "Only those willing to fail greatly can ever achieve greatly." So, we're willing to take risks. Calculated risks, but risks, nonetheless.

The third element of risk is that of ambiguity.

We don't know. No one knows. And if someone claims that they know, they aren't being completely honest. They likely have a 'model' that, when back-tested, has successfully predicted a past failure. What they don't share is that their 'model' wasn't successful predicting anything else with a great deal of certainty. We don't know if we'll succeed or fail. We don't know the extremes of failure or success we'll experience. We don't know when we'll succeed or fail. My speculation is this third element – ambiguity – is the worst of all. But we can take steps to mitigate the three degrees of risk. We can endeavor to fail greatly.

So, if we want to achieve greatly, how do we fail greatly?

We take prudent risks. We take steps to mitigate the risks we encounter. But we must take risks. We have to. John Shedd once said, ***"a ship in harbor is safe, but that is not what ships are built for."*** We were not created to be safe, careful, fearful creatures. We were created for adventure.

If this is true, then what are our options?

I believe that there are five options:

"There are risks and costs to action. But they are far less than the long-range risks of comfortable inaction."
John F. Kennedy

1 - The Ostrich Approach - Avoid risk at all cost.

Stick your head in the proverbial sand, pretend the risks don't exist and that they'll go away. The problem with this approach is that you might avoid the current risk you're concerned about, but you also avoid all the good things that are present with that risk. And having your head in the sand means that you're potentially opening yourself up to all kinds of other risks since you're not able to 'see' anything around you.

2 - The Transfer Approach – Transfer the risk to someone or something else.

By doing so, you could possibly minimize the risk because you're in effect, transferring the impact of the risk to someone else – you're abdicating the risk. While abdicating may relieve you of the impact of the immediate risk, the longer-term impacts do not fall away.

The cause of the 2008 Great Recession was based upon the foolish notion that one can "transfer" the risk of mortgage repayment

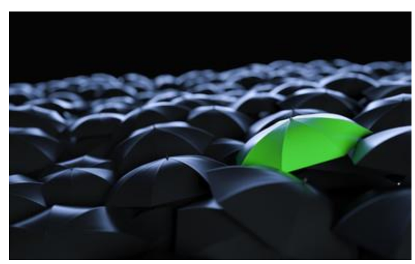
3 - The Fate Approach - Know risk exists and accept it.

"It is what a man thinks of himself that really determines his fate."
Henry David Thoreau

You can acknowledge that something has risk inherently included with it, and that there will likely be implications should the risk be realized. You have the choice to just accept that there is risk and believe there is nothing to be done about it. But if you can name something, then you can also take steps to minimize the risk and to prepare to address the risk. The easiest thing you can do for this approach is to learn about what you are facing. This can be accomplished either through internet searches (but be careful of the source of the information) or finding someone who has domain expertise in the area you are concerned about.

4 - The Umbrella Approach - Reduce known risk.

To mitigate something means to lessen the potential impact, to make the result less severe or harmful. Just like when you know it's raining you take an umbrella with you to avoid getting wet. Since you've been able to identify and name the risks you are (possibly) facing, you can take concrete steps to develop contingency plans to successfully address the risks. If you did do some research to learn more about the various aspects of whatever the risk may be, then you can also identify possible steps that you can take to address and/or mitigate them.



"Going around under an umbrella interferes with one's looking up at the sky."
Jerzy Kosinski

"Give me a lever long enough and a fulcrum upon which to place it and I shall move the world"
Archimedes

5 - The Archimedes Approach – Leverage risk in your favor.

If there is a risk of loss, there is also a risk (or to put it another way – the possibility) of gain. Archimedes discovered the laws of levers and pulleys which allow us to move heavy objects using small forces. Revisiting the third and fourth approach shared above in this regard is to find opportunities to leverage the potential outcomes to provide additional benefit.

According to Helen Keller "Security is mostly a superstition. It does not exist in nature, nor do the children of men as a whole experience it. Avoiding danger is no safer in the long run than outright exposure. Life is either a daring adventure or nothing."

There are concrete, actionable steps that you can take to minimize your exposure to risk.

To reduce the risk associated with ambiguity – the unknown – you need to start with a plan. A comprehensive, written plan that is based on rigorous analysis, actual historical data and solid fundamentals. Your plan should be as unique as you are. **You're not a 'cookie cutter' kind of person – your plan shouldn't be either.** Additionally, this plan isn't a "one and done" exercise. Your situation and status changes throughout your life. Your plan should also.

In addition to taking steps to offset the risk associated with ambiguity, **you can take steps to minimize the issues related to the risk of volatility.** Creating a customized plan that leverages the benefits of diversification of the holdings in your portfolio is a good start and you should be including that in your approach. However, there are other choices to consider. **Alternative investments, such as private equity and venture capital, can be less correlated to normal market returns of stocks and bonds.** They can also be higher in potential risk. But there are other types of alternatives that offer the benefits of reduced correlation, while also providing consistent and attractive returns. In addition to our proprietary Safer Equity Fund, we regularly include other alternatives in our client portfolios to protect against downside risk while also providing the benefit of non-correlated returns.

Finally, the type of risk most everyone is most familiar with, risk of loss, can be addressed through careful planning and constructing of a wealth plan that includes the customized selection of assets and investment vehicles that are based on rigorous fundamentals and are intended to best meet the needs, desires and understanding of your unique level of risk tolerance. This approach ensures loss-mitigating diversification and that your money is invested in the industries and markets that have strong and sustainable economic fundamentals.

I invite you to have a daring adventure. Never be afraid to try something new. Remember, if you risk nothing, you risk everything.

What risk are you facing today? What risk are you willing to take on today? Interested in more information about risk and your options? We would welcome the opportunity to share details about the proprietary technology and unique investment approaches we use to help clients build and protect wealth and mitigate risk. Contact us to talk through this topic in greater detail.

About Warren Financial: Since 1965, Warren Financial has been providing best in class services for wealth and investment management to high net worth individuals and couples. Building on the vision and legacy of the founder, Bill Warren – that each person has a unique purpose and desire to make an impact in their world – Warren Financial builds unique and focused plans for clients that deliver on the promise of serving our clients and enabling them to achieve their Greater Purpose tm. We believe that clients are unique and that their portfolios and investment strategies should also be unique. Using extensive research and analysis, including listening and understanding client needs and expectations, we create financial plans and models to best design the investment plan that best serves our clients' greater purpose. And then we execute. Consistently.

Office: Philadelphia Area	Office: Hilton Head	Office: Atlanta
Contact: Karen Copeland	Contact: John O'Toole	Contact: Bob McCarty
Phone: 610.363.2000	Phone: 610.363.2000	Phone: 610.363.2000
7 Dowlin Forge Rd.	2 Park Lane, Suite 202	Five Concourse Pkwy
Exton, PA 19341	Hilton Head Island, SC	Suite 3000
	29928	Atlanta, GA 30328