3Q 2014 Market Insights
The Changing Face of Portfolio Risk
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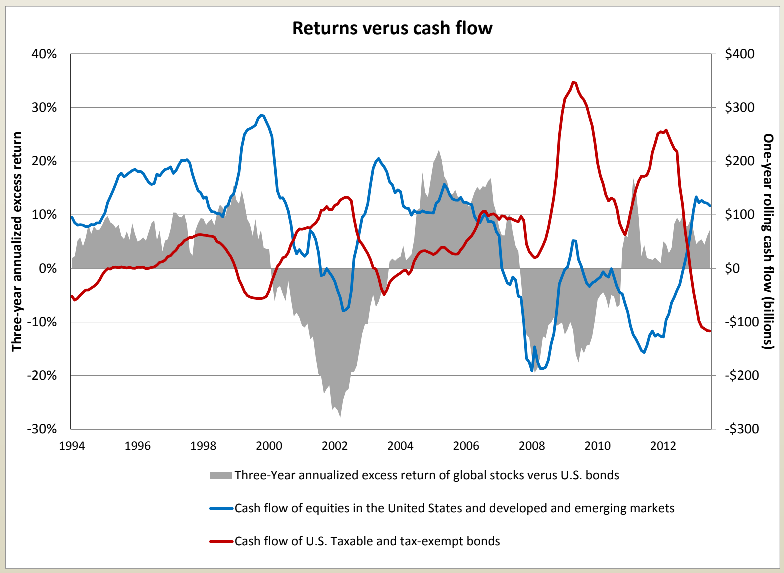
Integrated|Capital|Management

"You get recessions, you have stock market declines. If you don't understand that's going to happen, then you're not ready, you won't do well in the markets." - Peter Lynch

Investing is hard. No, I'm not speaking of it from the perspective of the money manager. I'm speaking from the perspective of the end investor, the owner of the pool of money. Investing is downright difficult. Why wouldn't it be? It requires the sacrifice of the fruits of your good old fashioned blood, sweat, and tears. It was done for some meaningful tomorrow; a wedding, a college education, a home or a comfortable existence into your golden years. All of these dreams are attached to high emotions. They have to be; otherwise we would never sacrifice our todays for tomorrows. It is that high emotion that causes us to want immediate results, to see incremental progress toward those results or to act to minimize pain as soon as the road gets bumpy. The very emotion that drives us to sacrifice in our earning years is the same demon that destroys sound investment strategies.



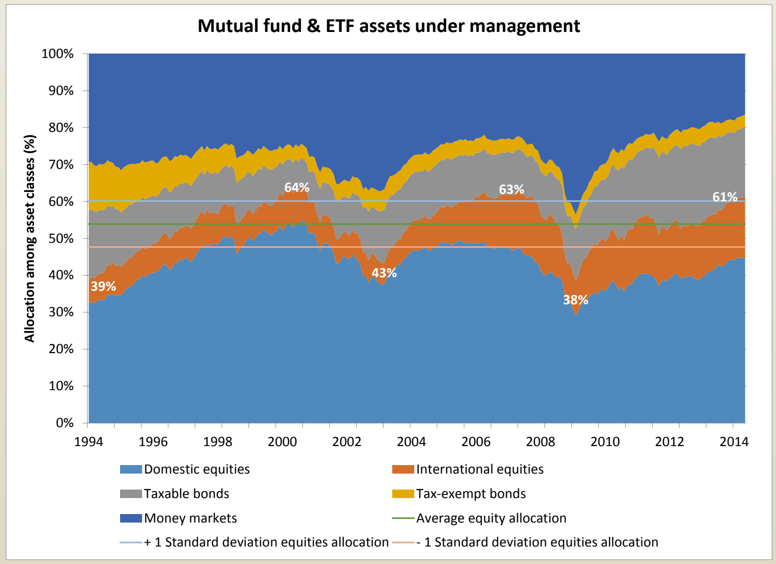
Investor cash flows tend to favor hot assets. As seen above this tends be a coincident indicator with market peaks and troughs and is reflective of a buy high and sell low pattern of investor behavior.

Data Source: MSCI, Barclay's Global Investors, ICI

The concept of risk in investing typically draws a powerful response. In many cases it is thought of as boom or bust; a win big or lose it all mentality. In most cases, risk is much less dramatic than that. With properly diversified long term portfolios, risk is usually nothing more than the roller coaster that we must ride on the way to our goals. It is the ups and downs that are synonymous with normal market behavior. The interaction between normal market forces and the highly emotional nature of people's hopes and dreams is the topic of this quarter's Market Insights. In particular, we explore what appears to be the dynamic nature of the tolerance for risk, the tendencies that investors exhibit as well as the systemic traps that exist within those tendencies.

Investors' Bad Behavior

Risk tolerance is a function of both one's ability and willingness to assume risk. While willingness is a personal preference item, ability will be influenced by such factors as time horizon and spending requirements. When properly specified, risk tolerance will serve as the investing speed limit on the road to our specific goals. Drive within that speed limit and we should be able to navigate the journey with little disruption. Exceed the speed limit and we run the risk of extending beyond our abilities to stay on course. But what if the speed limit changes? In concept, this sounds reasonable. Reduce the speed limit before a crash and increase it when all is clear. In reality, investors behave in exactly the opposite way. That is, they drive recklessly, on a narrow windy road overlooking a 300 foot cliff simply because the road behind them was straight and wide. Conversely, once they've experienced a wipe out, they decide it's time to drive at a slower pace. This can be seen in both bear markets of the past 15 years. Leading up to 1999, as valuations stretched to never seen before levels, investors kept their foot on the gas well into the 2000-2002 decline. Cash flows into equities didn't decline until 2002, after the damage was done. The same can be said for the 2008 decline. Poor performance led investor behavior, not the opposite. This can be seen in both investor cash flows into equity funds as well as the average asset allocation of all mutual fund and ETF investors. Equity investment peaked just as both bubbles burst and then declined to minimal levels as the market bottomed and was poised for a rebound. Good behavior? Hardly.

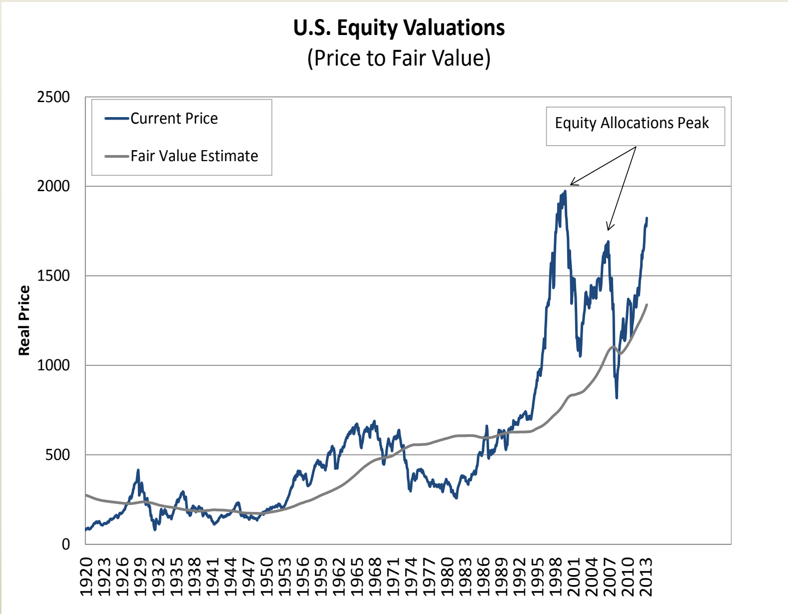


Like investor cash flow aggregate level asset allocation also tends to coincide with asset class performance with assignments to risk assets peaking at points when markets have performed well but may have become expensive.

Data Source: ICI, iCM Investment Research

Lion or Mouse, Which is It?

The pattern of increasing risk levels just as markets peak is telling for a number of reasons. The first, and most obvious, is that the collective intuition of investors or timing mechanism isn't very good. In fact, aggregate animal spirits to some is a contrarian indicator. A second, but more subtle observation relates to risk tolerance. By increasing the weighting to equities as the market rises, aren't we in fact saying that our risk tolerance (limit) has changed? But, why is it that our appetite for risk, or better said tolerance of risk, increases at the worst possible time? It appears as though human beings are wired with certain tendencies that make them predisposed to certain illogical but predictable errors. The field of study called Behavioral



As seen in the prior two charts equity cash flow and maximum equity allocation were reached in 1999 and leading up to 2008. This coincided with two vastly overvalued market environments. Investor tool on maximum risk at the worst possible times as depicted above.

Data Source: Standard & Poors

Finance,[1] studies psychological, social, cognitive, and emotional factors relating to investor behavior. There are several factors that explain the changing face of portfolio risk.

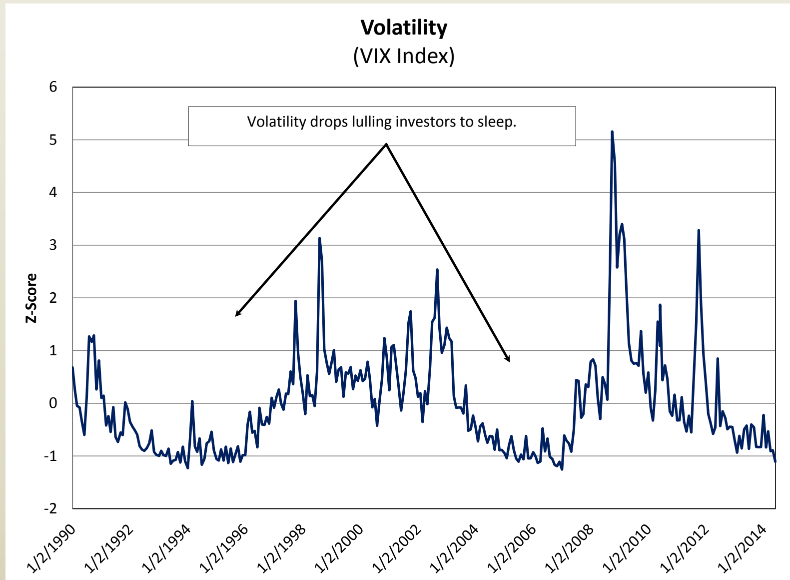
First, framing bias occurs when the answer given to a specific question is different depending on the way the question is framed. In the case of changing risk tolerance, the framing of the question is the movement of the market that causes investors to over, or understate, their aggressiveness depending on the direction of the market. This directly relates to two other behavioral biases, those being recency bias and herding. Recency bias occurs when an individual frames their point of reference based on events that have transpired in the recent past. Said differently, if markets have been good lately, the expectation is that it will stay good indefinitely. The last bias, herding, is the tendency of investors to want to do what their neighbors are doing. That is, they would prefer not to be wrong alone thereby missing what everyone else is capturing. All of these contribute to the psychological behavior that causes investors to overstate their willingness to take on risk in good times and understate it in bad. But is that the only culprit?

Volatility, the Sneak Attack

While individual investors certainly do themselves no favors, it's hard for us to say they are completely to blame for their own behavioral patterns. After all, we began this article by stating that investing is a tough slog. A contributing factor to this being difficult is volatility itself. Not that it would be easy to navigate the twists and turns that capital markets present, but it at least would be a fair fight if the target wasn't moving. Volatility across assets, but in this context most importantly equity volatility, isn't constant. It ebbs and flows, crosses peaks and valleys. How is that surprising or problematic you might ask? It is mean reverting. That is periods of high volatility are followed by periods of low volatility, but more importantly, low volatility is followed by high. As investors set their portfolio risk in line with their ability to tolerate that risk, it moves making more aggressive portfolios appear safer than they are. Therefore, investors can be lulled to sleep during bull market advances by both good performance, expensive valuations and lower than normal volatility. This, in our opinion, has as much if not more to do with overstated risk tolerance during goods times. Said differently, volatility tends to be below average at exactly the wrong time making it easy for folks to chase returns and take on additional risk. That is, you don't feel the volatility until it's too late.

[1] The New Palgrave Dictionary of Economics Online

We began this article with a quote from the legendary Fidelity Magellan fund manager Peter Lynch. *"You get recessions, you have stock market declines. If you don't understand that's going to happen, then you're not ready, you won't do well in the markets."* Not only are most investors surprised by these things, they compound them by becoming more aggressive at the worst possible time. Some would argue that this could be attributed to changing investor risk tolerances. While we would allow for that possibility, we would argue that a changing preference for risk is driven at least partially by the changing nature of volatility. As always, we encourage you to work with your financial advisor to develop well thought out plan and stick with it. Don't be lured into *The Changing Face of Portfolio Risk.* Thank you for your trust and confidence.



While some would point to behavioral influences altering investor risk tolerance, we would argue that the changing nature of volatility is at least partly to blame. That is, investors can be lulled to sleep by low but mean reverting market risk as see above.

Data Source: CBOE

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