MANAGING PORTFOLIO RISK

Since the low point in early 2009, stock and bond markets have generally enjoyed positive returns. However, the memory of volatile prices and painful losses remain, causing investors to cast worried looks over their shoulders and to contemplate ways of protecting or "hedging" their investments against risk. But, is it even worthwhile to attempt to hedge portfolios against market risk? What choices are available? What do they cost? How and when should they be used?

Which Risk?

One of the first steps is to decide which risk you are trying to guard against. For example, it is easy to avoid the risk of what may happen to stock market prices – just totally avoid the stock market and buy U.S. Government bonds. Ah, but now you are exposed to risk of what may happen to your bond values when interest rates begin their long-anticipated rise – so you decide to park your money in a savings account. But you earn hardly any interest on the savings account and know that ultimately the returns there won't keep pace with inflation. Besides, there is an opportunity cost you incur by not being invested and sitting on the sidelines. So, what do you do? Given your own particular situation, you need to ask, "What are the biggest risks for me? Given my time frame and goals, which risks should I be accepting and which should I try to protect against?"

Asset Allocation

Your answers to the above questions will determine your asset allocation. It could result in you being primarily invested in guaranteed assets or bonds, holding a balance between bonds and stocks or having a mostly equity portfolio.

Changes Within Your Allocation

Without necessarily disturbing your long-term asset allocation, you can lower your risk by making changes within your allocation. For example: For the bond portion of your portfolio you could move slightly away from higher-yielding (lower quality) corporate bonds and towards higher-quality (but lower yielding) corporate bonds. You could also shift somewhat from mutual funds that own smaller stocks to those owning larger ones or from funds that follow a growth-seeking momentum strategy to a more conservative value-oriented approach.

Go to Cash

Of course, you could also decide to temporarily exit the bond or stock market entirely and sit on the sidelines. However, in today's low-yield world, you earn virtually nothing by sitting on cash - but you do at least have some peace of mind that you won't see any investment declines. But this is a not a long-term strategy and if you go to cash you also have to have a plan for how and when you will be moving from cash and back into longer-term investments.

Buy Insurance

You can effectively buy portfolio insurance through the use of financial derivatives, such as options or futures contracts. Just like any insurance, an investor using derivatives to protect a portfolio has to be aware of the cost (the insurance premium), the deductible, and the length of the policy. Buying portfolio insurance might be an appropriate strategy for a short period of time, such as when someone is worried about a particular global event that may or may not happen or an upcoming election. However, keeping a permanent portfolio hedge in place through derivatives costs too much and robs you of whatever return you were hoping to earn.

Alternative Investments

There are many "alternative" investments today that pitch themselves as alternatives to traditional stock and bond investments. They appeal to the idea of being able to earn money regardless of what the overall market is doing. They go by many names, such as: structured products, long/short equity, market neutral, managed futures, macro allocation, etc. The biggest thing to consider about any of these alternative strategies is why you are using them. They often lag behind more traditional investments, which make them difficult to own when the sky is sunny. You own these types of investments for the cloudy days, but it doesn't rain that often, and I believe alternative investments should be a minor player – not the featured act – in your portfolio.

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