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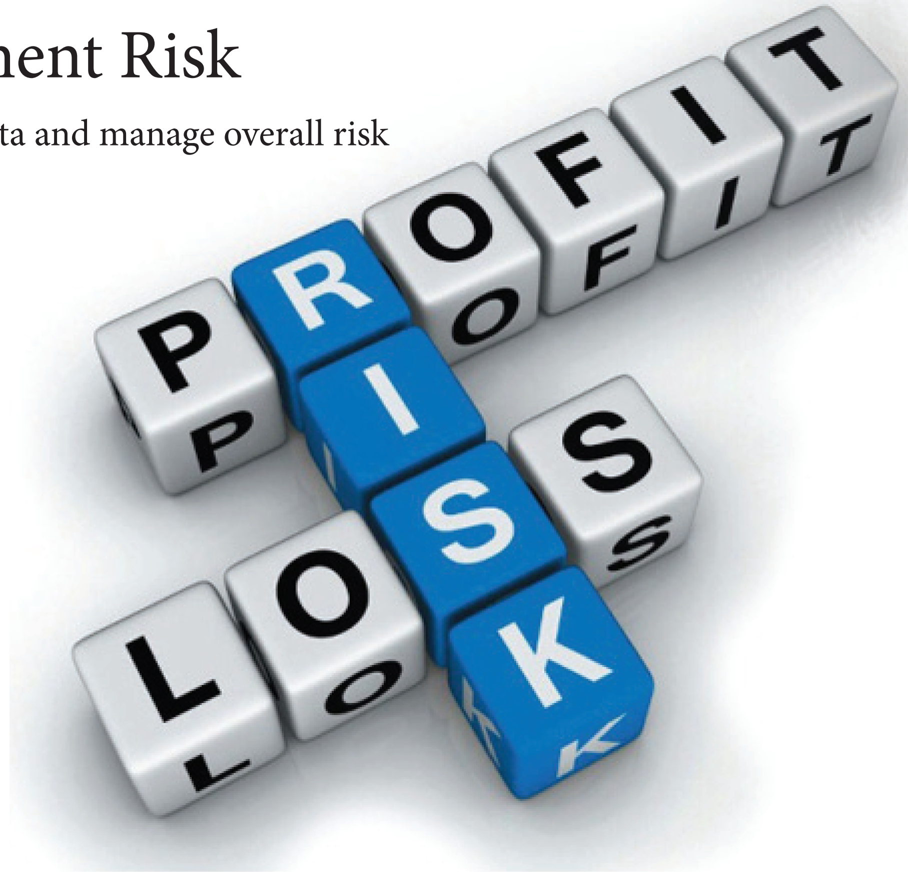
NAIFA's advisor Today

Managing Investment Risk

Monitor economic and market data and manage overall risk



Investors holding stocks from the decline of 2008 may be feeling better, but U.S. equities are still well below their 2007 highs. In fact, the S&P500 entered 2011 at the same level as it did in 1999.

Today's investment environment is crowded with risks built up during the 20-year bull market. As investment advisors, we expect adversity – there is always something negative to cull from economic and market data. Today's problems, however, are largely due to an overleveraged global economy; a fundamental characteristic is rarely encountered.

Undercurrents in the big economic picture suggest the frequency of sustained market declines may be higher than normal. Perhaps the proposed austerity measures to reduce government spending will help. Perhaps the proposed growth initiatives will deliver needed tax revenues.

But while we wait to see, investors can't afford to sit on cash. If they want growth, they must expose their investment dollars to some risky assets.

How do you invest in markets when you are not confident that current conditions will be sustained? Obviously, you must stay informed, but how best to do that? One way is to track indicators that are effective in monitoring the health of the economy and the markets. Here are two I follow:

Leading economic indicators

The conference board publishes business cycle data via leading economic indicators of the U.S. and other countries. The correlation between the business cycle and stock markets has historically been strong. Many analysts believe leading economic indicators provide a reasonably accurate view into the near-term condition of the business cycle, and that a decline in these indicators may be an early warning sign of a coming recession.

The action of security prices around a moving average can also tell an important story. Stock prices must take an occasional rest, and a pullback to the 50-day moving average, or even below it, is normal. Using the 50- and 200-day moving averages as floors and ceilings, you can gain perspective by watching the price action around these levels. You might also find a review or S&P500 price action during 2007 and 2008 helpful. 2000 through 2003 tells a similar story.

Managing risk today

Following economic indicators and market prices can be more of an art than a science. Here are a few alternative strategies for managing risk in the global economy.

Consider examining your asset-allocation percentages. It might be a good time to wear a down jacket even if it appears only a windbreaker is needed; reduce the risk level across the spectrum.

Some advisors are advocating strategies that aim to capture 75 percent upside but only 35 percent of the downside relative to a benchmark.

You might also pinpoint strategies within asset classes, such as reviewing the duration of your fixed-income investments, examining municipal holdings with a critical eye and checking the standard deviation and yield of your equity investments. While aggressing growth companies are exciting to hold, they can be the most difficult during challenging periods. You might also consider investment managers with the flexibility to generate cash.

Consider implementing alternative investments, such as a commodity complex, real estate investment trusts (although right now may not be the best timing for REITs), business development corporations and master limited partnerships. MLPs are tied to the energy complex, so be careful not to over allocate if you have energy commodities in your asset allocation. You might also add a currency component or a manager features fund for exposure to commodities and currencies.

Absolute return funds can provide value in the form of low volatility, low correlation and positive compounding. Low equity-like returns with bond-like volatility can be highly desirable in our current environment. Well-managed absolute return investments in an asset-allocation strategy can be a key component in capturing most of the upside while minimizing the downside in benchmark volatility.

If you manage stocks or exchange traded funds, consider using stop or stop limits of your positions. The May 2010 Flash Crash caused some to lose faith in stop-loss orders but using a limit in conjunction with a stop order can help prevent your order from being triggered when prices fall below your protections level. A limit also means you will still hold the investment if the market moves past your limit before buyer arrives.

With concentrated stock positions, consider protective puts, which can lock in value should a stock or ETF price fall and remain below the put price. This strategy can also be helpful around earnings season.

The real risk for investors today is running out of money during retirement. During accumulation, investors have time and dollar cost averaging to help correct mistakes. During the spending years, the opposite is true. As severed downturn in account balances at the beginning of retirement withdrawals can be devastating to retirees.

2009 and 2010 have been outstanding recovery years, thanks to the resilience of the U.S. economy, along with a little policy goosing.

Trouble is, not much has changed fundamentally. Some austerity is under way in Europe, China is trying to rein in lending and curb inflation, and the U.S. is cutting taxes and increasing spending. Perhaps the global economy will balance everything out and we will return to the exuberant market of the; 80s and '90's; but history suggests otherwise. Our best course of action may be to diligently monitor a few key pieces of economic and market information and implement some level of overall risk management in client accounts.

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