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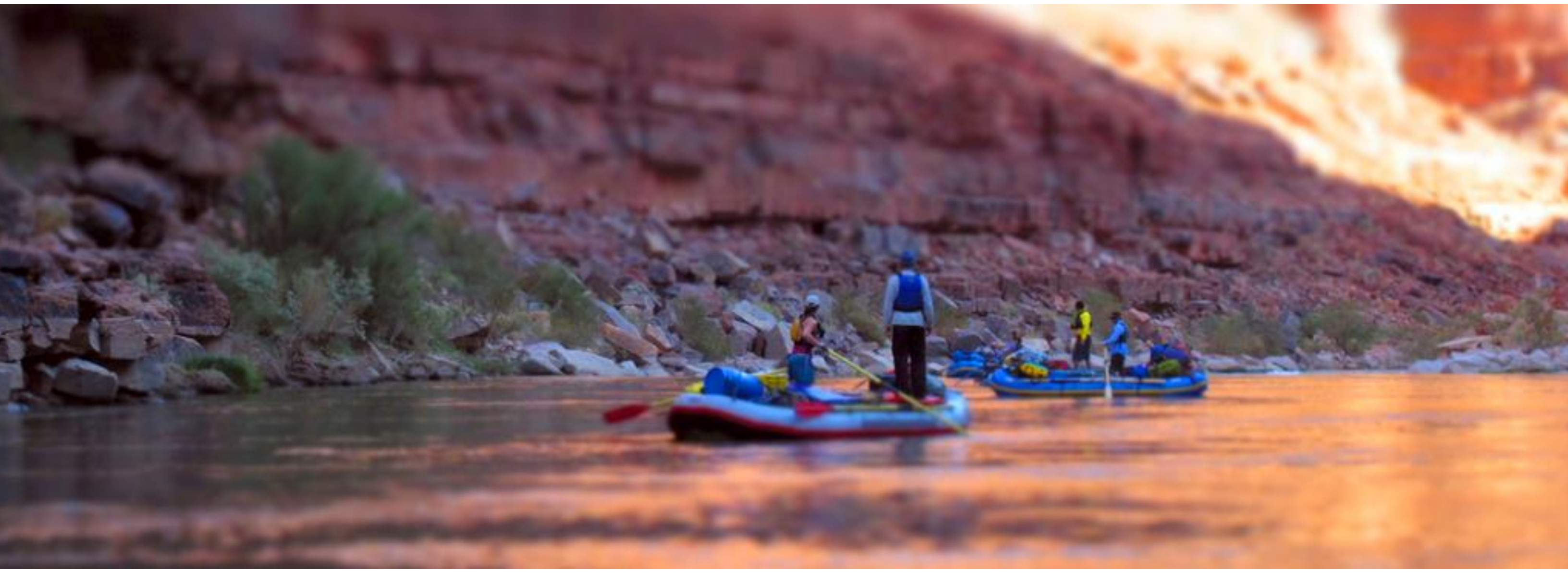

Active Risk Management.

The most important thing I can offer my clients is a sense of clarity about their investments, and why they were chosen over myriad other opportunities. The lion's share of that clarity needs to be rooted in a long-term strategy they relate to both intellectually and intuitively. In order to be completely satisfied, however, they need something more; a sense of self-determination. That is something I really can't offer at the outset as we build and discuss our portfolios. But I do hope to deliver it over time by introducing them to a more nuanced understanding of risk management.

As I look at the current market environment, I'm torn by two opposing dynamics. While I'm comfortable with the earnings and productivity of the businesses we own relative to what we paid for them, I'm concerned from a statistical perspective that we are in a bull equity market now in its late 3rd year of life. All things have life spans – and since 1932 the lifespan of a bull stock market has been 3.8 years on average, with a median span of 3.6 years. While some bull markets have been as short as 9 months, and others have been as long as 9 years[i], the plain statistical fact is that this particular bull is now middle age.

Unfortunately, this mathematical reality also needs to be viewed within the context of gravely indebted Western governments, and unusually high market volatility over the past decade. In combination these factors are very significant – enough to worry even the staunchest long-term equity investors. But are they enough to warrant abandoning ownership of productive businesses? Most certainly not. We make our investment returns by owning both fairly-valued and under-valued businesses like those currently in our portfolios. These adverse macro-economic conditions do, however, make me want to educate clients about the array of risk management tools we have at our disposal.

A fellow Bostonian, albeit one very much older and wiser than I, can help us frame this discussion. Oliver Wendell Holmes Jr., the Supreme Court Justice, Yankee Civil War veteran, and protector of free speech once said *"I wouldn't give a fig for the simplicity this side of complexity, but would give an arm for the simplicity on the other side of complexity*."

In investing, the simplicity we don't give a fig about is the commonly used approach of selling off pieces of a perfectly good portfolio to reduce market risk. Sure, it's straightforward, but it has a wide range of ugly knock-on consequences. If we make a habit of selling frequently we will incur unnecessary tax liabilities, increase administrative hassle, drive up commissions, and sacrifice the coherence of the portfolio. It's a very blunt approach to risk management.

In the middle is our well-rounded investment portfolio – the complexity we are working across. Our approach is to put significant effort and patience into constructing portfolios by seeking distressed sellers of high quality assets around the world. We then make conservative estimates of the long-run yields we expect from those assets, and dovetail them together in specific concentrations to provide *meaningful* diversity. We don't proliferate investments mindlessly using only historical correlations as many advisors do – thus ensuring mediocrity. Nor do we make highly concentrated investments – thus increasing our risk of ruin. Instead, we place unusual emphasis on investing across key macro-economic divides like trade balances, monetary environments, and economic liberalization profiles. All this selectivity provides a level of protection that has both quantitative and qualitative elements, and should result in our portfolios performing better than most over the long-term.

All that said, no matter how well this strategy is executed our portfolios will still be heavily influenced by the general trend in markets. This is the price we pay to participate in business earnings, dividends, and the fruits of innovation. Surprisingly, it's this very influence of the broad market which creates the valuable simplicity we are looking for. We can quantify the influence of the market on our portfolios with a metric known as *beta*. This number lets us connect our portfolio's performance through statistics to the ever useful S&P 500. A portfolio with a *beta* of "1" can be expected to increase in value by about 1% when the S&P 500 increases by 1%, while a portfolio with beta of .75 can be expected to move less, about .75% when the S&P 500 moves 1%, and so on. Our portfolio *betas,* inclusive of cash, happen to be running in the .66 to .85 range recently. With particular account information at hand, those figures make it possible to manage the majority of a complex diversified portfolio's market risk using only the S&P 500.

In discretionary accounts, I utilize two primary risk management strategies. The first is short-selling of stock indices like the S&P 500, and the second is the sale of *covered* call options on both indices and individual large-capitalization stocks. Each of these tools, while different, has the net impact of reducing *beta,* dampening portfolio volatility, and limiting exposure to the direction of markets. They also avoid many of the difficulties created by the outright sale of assets. They are flexible, scalable, and allow me to apply the brakes with precision according to the risks at hand.

In the case of short-selling, I structure a transaction in the S&P 500 to offset market risk by 25%, 33%, 50% or more as the situation merits. While this transaction requires a margin account, due to the fact that we are selling short we collect cash credit immediately on the sale, and thus don't accrue interest as we would if we were investing long on margin. All we are typically liable for is the dividend of the stock index if it is paid while we are short. In certain environments, to reduce that drag, I might elect to sell short a smaller capitalization index with lower dividends like the Russell 2000. But in most cases these risk management transactions don't have especially long durations, and thus will generate little negative dividend friction. Further, it's important to understand that any friction remaining will then be offset by the collection of the positive dividends paid by the underlying portfolio, as it remains operating undisturbed. When done well there will still be a positive expected yield from the portfolio despite the reduced market exposure.

If this sounds complex, which it really is not in practice, let me put it in practical terms. A short stock index transaction like this means that on a nasty down day the portfolio will show proportionally less negative change in value despite the fact that no core portfolio assets have been sold, no tax liabilities crystallized, nor any decisions made about what to sell and what to keep. In trained hands, the short-sale of indices is clean, quickly actionable, and structurally sound. When it comes time to return our market exposure to where it was before we took action, we don't need to evaluate new investments; we simply close our risk management position and thus automatically resume our prior stance.

The sale of *covered* call options, the other tool I use, is more subtle. What it essentially allows us to do is become a banker to other investors. When we sell a call option on a stock or fund we already own (which is what makes it a *covered* call,) we sell another party the right to buy that particular stock or fund from us at a certain price on a certain date in the future. In return, they pay us cash now. The amount they pay relates to how attractive the price and timeframe we offer is. While technically a "derivative" strategy, with this approach we are selling the derivative, not buying it, and thus get to hold the real assets ourselves (the cash and the stock,) while they hold the paper contract – an arrangement I find very attractive.

Since I generally only sell “out-of-the-money” call options, that means we retain some potential upside in the stock for ourselves, while delivering a long-shot investment to the other side of the trade. While this strategy does put a cap on our potential gains, it limits our potential losses as well, thus reducing overall portfolio volatility. As with short-selling, our downside occurs if the market rallies while we are managing risk, and we don’t participate in the rally to the extent we would have otherwise. While missing out on a piece of a good rally is tough from both a performance and psychological perspective, in most cases when I sell these calls I have a price and time frame in mind at which I would be happy to sell the underlying stock or fund anyway. As a result I don’t see it as opportunity cost because I would have been considering selling the stock at that price regardless. Selling options also allows me to employ observations about volatility in the market, and to take advantage of persistent weaknesses in how human beings perceive time. *(Call me on that one. I can promise an interesting conversation.)*

In other instances, selling call options can help us manage mature investments that have low cost basis. If an account holds highly-appreciated stock on which the IRS would have a sizable claim, we can sell covered calls in an effort to increase the investment’s current income and reduce risk without triggering a taxable event in the underlying shares.

So you’re probably wondering if these are such great risk management strategies, why don’t more advisors execute them for clients? The answer lies in the format of the industry. Most advisors feel they are paid to pick *which* investments clients should have, but the decisions of *when* or *how much total* to invest belong to the client alone. This is convenient for them because they get to abdicate the most difficult, but highest-added value decisions. Personally, I find it a bit disingenuous. You would obviously hope your advisor – who you are paying – would help you with these difficult and high-value decisions. It is also misleading because many of these same professionals are not following their own advice and are making more frequent decisions for their own accounts.

Market timing is clearly a controversial subject in the investment industry. The vast majority of advisors and institutional consultants will tell you it’s both dangerous and fruitless to attempt to time the market. That opinion lines up conspicuously with how they bill – as a percentage of assets under their management. On the other hand, go into an investment banker’s office and they will tell you the opposite. They will likely say timing is everything, and the right time is now! That is because they get paid per completed transaction. So what is the truth? My personal experience has shown me that most all major successes in business do, indeed, have a component of good timing.

I’m not scared to admit timing is a very important factor in what successful investors do. In a way, it may be the most important factor because almost all investment models will show you the price paid for an asset has the most control over the results of the investment—and the price paid is of course intimately linked with shrewd timing. I reflect regularly on a simile of Shakyamuni Buddha’s: *“Just as the elephant’s footprint eclipses all other footprints in the jungle, so too does timing eclipse all other qualities in trade.”*

Now, having respect for timing and running around foolishly hitting the on/off switch are two very different things. The times we want to manage risk are rare, and they share certain characteristics. For example, we generally *don’t* want to manage risk around assets we think are over-valued. Unless those assets have some strings attached, we want to sell them outright in order to buy new assets with better valuation. That is ultimately how a value investment portfolio generates returns over time. Similarly, we don’t want to manage risk around under-valued assets as their under-valuation is our first line of defense against risk as it is. Counter-intuitively, this leaves only fairly-valued assets.

So how do you manage risk in fairly-valued assets? Wouldn’t it be easy to botch that and watch your investments head into over-valued territory without benefiting? It certainly would be. In fact, there are really only two instances when it makes sense to take action. First is when an investor’s goals or cash flow needs (and therefore risk tolerance) change unexpectedly. In that situation it makes sense to manage risk first, and then deconstruct the portfolio to fit these new goals in a controlled and disciplined manner. You *never* want to be put in a position where you are forced to sell investments under duress. As you know, we buy from distressed sellers, and try hard never to become one.

The second instance arises when the market itself changes. While there are a number of valid approaches, in my opinion the only *consistently* effective approach is to be pre-emptive. That is to say, move before trouble is visible. I find the highest probability starting place is a market for fairly-valued assets that has recently seen a strong move higher, where investors are showing profits and feeling proud or complacent. No obvious reason for worry has yet emerged.

When this sentiment has developed, I then look to a range of technical indicators like volume, volatility, short-interest and news flow. These days, you also have to closely evaluate where markets are relative to where central bankers want them to be, and also when they plan to talk about those aspirations publicly. Depending on how all these indicators reinforce or offset the inherent weakness of a complacent market, I will start to slowly apply the brakes in an attempt to preserve capital. As a client, you will be surprised to hear from me at these times. Things will look and feel pretty safe, and the news will be positive. But it is exactly times like these that I have trained myself to get concerned. These are the rare moments when I see the potential for downside being more than twice the potential for upside in the near term, **and** can visualize some potential catalysts to expedite it. They are high-value moments where I think protecting your capital is more important than growing it. Under these conditions it makes sense to execute our risk management plan and reduce exposure cleanly and decisively. By using a pre-emptive rather than reactive approach, we can act patiently and rationally while utilizing market strength to our advantage.

Global markets will always have a range of risks we can't avoid if we seek any sort of investment returns. As investors we are paid exactly because we bear a certain amount of this risk and uncertainty. The majority of the time these risks will be well-balanced versus the rewards we stand to gain because our underlying investment purchasing strategy seeks to respect that relationship. But as both an investor and advisor, I recognize there will be times when that balance becomes skewed in the wrong direction.

I don't have unrealistic expectations that we will see each of those problem moments arising. Nor do I expect to know the exact beginning and end of those we do see. But I can help my clients participate in the market with a self-determined confidence that flows from having a well-considered and comprehensive plan to actively address those risks we are fortunate enough to witness. With this blueprint and these honed tools, we don't need to feel like a distant observer in the global economy. As a matter of fact, we stand a very good chance of paying only a few figs for what that costs most people an arm.

Enjoy your Independence Day,

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[i] InvestTech Research LLC