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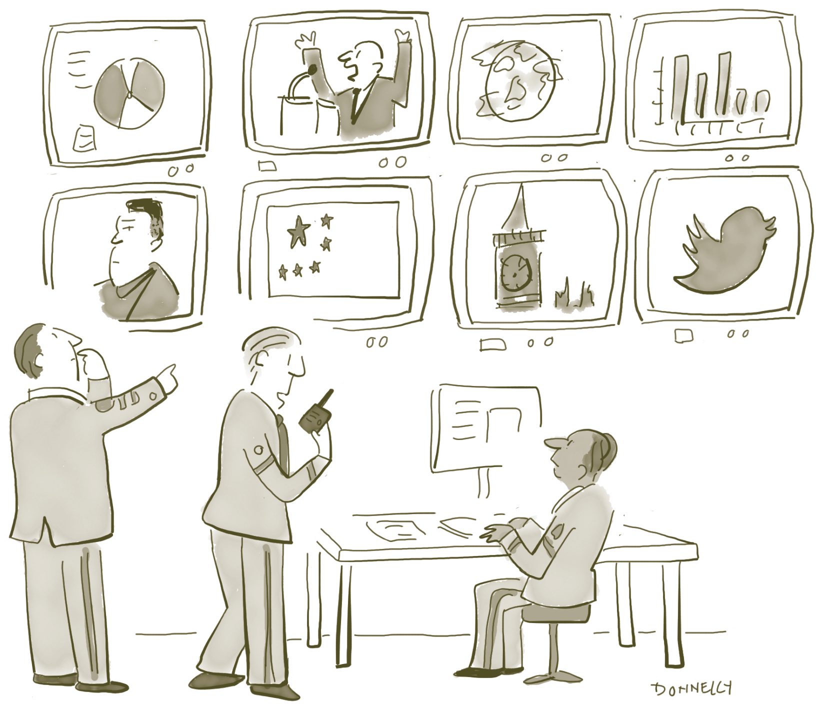
# HOW WE MANAGE RISK




In his 2015 memo "Risk Revisited Again,[1]" Howard Marks, one of the great investors and financial thinkers of our time, dedicated 20 pages to discussing more than 20 different risks that come with investing. In "Avoiding Unintentional Risks," an article in the Winter 2017 issue of INVESTED (compassionately brief by comparison), we defined and discussed some of the investment risks we believe are most important to assess. While identifying and defining risks is an important exercise, a subsequent question from our clients might be, "What are you doing to prepare my portfolio for these potential risks ahead?" This article attempts to answer that question by providing an overview and some examples of how we manage risk from a practical application standpoint. »

We agree with Marks's statement in his memo that "the task of managing risk shouldn't be left to designated risk managers." Many people at RMB play a role in managing the risks in our clients' portfolios, from those who determine overall asset allocation and portfolio positioning to those who manage strategies and determine which securities to buy and sell. And we use various processes and technological tools to assist in the effort.

## Portfolio Risk

At an overall portfolio level, diversification is key to managing risk. Marks helps us understand why when he writes that "investing requires us to decide how to position a portfolio for future developments, but the future isn't knowable." In acknowledgement of this indelible truth, we build portfolios we believe can weather a range of future outcomes. Experience shows that simply diversifying away from large-cap U.S. stocks into small-cap or international stocks is not enough because they tend to suffer declines at the same time. Bonds—typically viewed as a "safety net" relative to equities—are an important component of most diversified portfolios, but they are not immune to downturns. So, in most client portfolios, we also include real assets[2] and absolute return[3] investments, as these asset classes are driven by different factors and their performance can zig when that of stocks or bonds zags.

The optimal asset allocation for each client will change as market conditions and client circumstances evolve. For example, after a strong bull market in which stocks have appreciated in value, a clients' equity allocations may have a larger weight in their portfolios than we consider prudent. Compounding the issue, stock valuations are generally higher after a run-up in price, making them less attractive on a forward-looking basis. We proactively take opportunities such as these to rebalance portfolios back to target weights, thus reducing equity market risk. The line can be blurry between the problematic technique of "market timing" and the more embraced "tactical asset allocation," but, in extreme circumstances, we also update our assessment of the optimal asset allocation. For example, after a strong bull market and with equity valuations high, we may decrease our clients' target weight for stocks in light of the increased risk that lies ahead.

## Investment Strategy Risk

At the individual investment strategy level, we employ many techniques to manage risk. For example, we generally keep the duration of our bond portfolios short. Shorter-maturity bonds are less sensitive to the adverse consequences of rising interest rates.[4] While longer-duration portfolios have more upside in steady markets or when rates fall, shorter-duration portfolios also provide an element of safety and diversification relative to stocks, and don't go down as much in price when interest rates rise.

Another strategy-specific example is our focus on high-quality companies in our equity portfolios. There is no universally agreed-upon definition of the term "quality" in equity investing, but we consider a stock to be high quality if the company is well managed, stable, profitable, and has good growth potential.[5] Our research shows that high-quality stocks tend to outperform low-quality stocks and broad market indices in market downturns; thus, a focus on them is another way to manage risk.

## Risk Management Tools

In addition to the various techniques we employ to manage risk at the overall portfolio and individual strategy level, we have a number of tools at our disposal to help us measure and characterize the risk of our investments. Quantitative analysis is an important part of this exercise. We use industry tools such as Bloomberg to measure the value at risk (VaR), an estimate of how much an investment might lose in a set period of time, and liquidity of our portfolios, and we run scenario analyses to project how they might behave in a variety of historical or hypothetical stressed environments. We have also developed proprietary technology to assess risk, which we think gives us a leg up on other investors. One example is » our application called Alphacuity, which uses option-implied volatility (the options market's forecast of the likely movement in a security's price) among other inputs to measure risk in equity portfolios across a variety of metrics such as market risks, industry risks, and position sizing. Analyzing past performance in an attempt to extrapolate potential future trends can also provide insight. While quantitative analysis is valuable, we believe there is no single way to measure risk, and that the risk of an investment cannot be boiled down to a number. Risk is best understood by combining qualitative and subjective assessments to create a mosaic that provides a more robust view.

## Conclusion

To quote Howard Marks one more time, "The future should be viewed not as a fixed outcome that's destined to happen and capable of being predicted, but as a range of possibilities and, hopefully on the basis of insight into their respective likelihoods, as a probability distribution." By constructing portfolios of truly diversified assets, we strive to build portfolios that will weather a range of potential outcomes. Thoughtful asset allocation and rebalancing decisions are part of a continuous process to ensure that our portfolios are tilted toward what are, in our assessment, the most likely future scenarios. Each of our individual investment strategies uses various techniques to prepare for volatile times, and, while we embrace technology and a quantitative approach to risk management, we believe the "art" of qualitative assessments is at least equally important.

Over the last few years in particular, we have been preparing our clients for increased volatility ahead. Volatility did indeed rear its head in the fourth quarter of 2018, and we expect more to come. While it is painful when asset prices go down, it also presents opportunity, which brings us to one final risk to mention: the risk of falling short, i.e., not taking enough risk to earn a return sufficient to meet one's investment objectives. The future is never certain—waiting for the intersection of cheap prices and a safe outlook will leave one permanently on the sidelines. While staying fully invested, we prepare for periods of volatility by managing risk in advance and by being prepared to play offense when volatile times come. ■

1 *Howard Marks, "Risk Revisited Again," Oak Tree Capital, June, 8, 2015, https://www.oaktreecapital.com/docs/default-source/memos/2015-06-08-risk-revisited-again.pdf.*

2 *To learn more about real assets, read our article "The Role of Real Assets in Investor Portfolios" in the Summer 2013 issue of INVESTED.*

3 *To understand how we define absolute return, check out our article "Asset Class Overview: Absolute Return" in the Winter 2018 issue of INVESTED.*

4 *For more on bonds, see our article "Bond Mechanics & Fixed Income Markets" in the Winter 2015 issue of INVESTED.*

5 *Our article "The Case for High Quality," from the Winter 2019 issue of INVESTED, delves deeper into why high-quality investments are so important.*