

Managing Investment Strategy and Planning in an Era of Increased Market Volatility

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You don't need a crystal ball to predict the state of heightened market volatility that is emerging as the new framework for investment decision-making.

How investors manage volatility in this new environment will help define successful investment strategy and planning in the next decade.

For ultra high-net-worth investors who have already earned their wealth and are seeking to preserve it, the downside of volatility typically carries more weight and is a more sensitive issue than the upside alone.

This article therefore reviews the emergence of heightened volatility, reasons for it to continue, and the implications for ultra high-net-worth individuals and families in establishing investment strategy and planning for the future.

VOLATILITY OF THE LAST DECADE

Volatility is more significant now than at any time in the past seven decades. We know that a cursory glance at the S&P 500 over the last decade shows a period that was one of the most capricious and fickle in financial market history.

Of the 20 largest one-day surges in the post-war era, 15 have occurred in the last ten years. More importantly, those large advances came with some memorable declines; the plunges associated with failing banks in 2008 rival similar panics previously only associated with the currency devaluations and bank runs of the Great Depression.

Additionally, the years 2008, 2002, 2001 and 2000 rank 2nd, 6th, 8th and 13th, respectively in annual declines since 1926; the largest advancing year (2003) ranks just 19th among the winners.

The frequency and magnitude of recent volatility has popularized the terms “fat tail” and “black swan,” and managing these phenomena is a burgeoning area of interest to investors and their advisors. Not surprisingly, according to an article in the August 21, 2010 edition of *The Wall Street Journal*, *Preparing For The Next Black Swan*, the investment management industry has responded by forming at least 20 hedge funds specializing in protecting against tail risk.

VOLATILITY YET TO COME

Despite the fact that the National Bureau of Economic Research recently announced the end of the recession (according to the NBER it ended back in June 2009), the Standard & Poor's 500-stock index has reached two-year highs, and the mid-term elections are behind us, there remains plenty of uncertainty to fuel higher levels of market volatility going forward:

- **High unemployment** – cyclical or structural?
- **Unconventional monetary policy** – a repeat of unintended consequences?
- **Unsustainable fiscal projections** – how will the solutions play out?

These economic, monetary, and fiscal conditions have already pitted gold and Treasury yields in a tug-of-war, stretching the price of gold and 10-year Treasury yields in opposite directions. One of them has to win and the victor is again uncertain.

Last but not least, the humbling “Flash Crash” of May 2010 portends that if all else goes right, the market's infrastructure itself may result in unexpected surprises.

IMPLICATIONS FOR INVESTMENT STRATEGY AND PLANNING

The implications of volatility that is higher in frequency and magnitude on investment strategy and planning is both informed and challenged by our experiences of the last decade.

For example, those experiences have brought to bear limitations in the previously advertised benefits of a “fully diversified” portfolio and the mass realization that leverage can indeed be risky. Concepts such as the meaning of illiquidity and the need for transparency have also moved to the forefront of the discussion.

Keeping these experiences in mind, we offer the following recommendations on developing sound investment strategy that integrates income and estate tax planning ***in an environment of higher volatility:***

“Volatility may provide great opportunities to implement a variety of investment and planning strategies.”

1. Focus on a “Dual Asset Allocation” approach to investing.

Of all the decisions made when creating a “fully diversified” portfolio, there are only a few that drive the majority of the risk reduction benefit.

Decisions that include the allocation to “return seeking” or higher volatility assets as opposed to “lifestyle hedging” or lower volatility assets is the primary driver of risk reduction. This “dual asset allocation” approach is a simplified but very effective way to think about investing and manage risk. Diversification across an adequate number of securities within the “return seeking” bucket is assumed with concentrations in any one security significantly increasing risk.

Many of the other diversification decisions such as allocation across major marketable equity asset classes (e.g. U.S. vs. Non-U.S.) and sub-asset classes (e.g. large vs. small capitalization stocks), can be of value during times of “normal” volatility but have shown to be of lesser benefit when really needed over the past decade.

2. Consider the “fat tail.”

Asset allocation, most importantly the mix of “lifestyle hedging” and “return seeking” assets is often established based on the investor’s comfort with the range of returns associated with the portfolio under a “normal” distribution, or bell curve.

It’s typical for investors to evaluate the range of returns as those falling between the 5th and 95th percentiles of the distribution with the 95th percentile defined as the “worst case” — but is it a fair representation of the worst case?

You can select an asset allocation that will help you sleep better at night if you understand that, given the events of the past decade, as well as expectations for the future, we may face more “worst case” scenarios, and they may be of greater magnitude. This variation from a normal bell curve is called a “fat tail.”

3. Know what you are investing in.

In 2008, we learned that when markets make a big turn south, illiquidity and leverage matter and their combination can be particularly detrimental to portfolios. Of course, transparency, which many investors did not have with respect to many of their portfolio investments (especially hedge funds), was critical for understanding the degree of illiquidity and leverage on hand. Even where total transparency was available, investors were apathetic in their assessment of risk (e.g. disregarding the risks of residential mortgage backed securities), even underestimating potential dangers lurking in high quality corporate bonds.

Investors absolutely must assess liquidity and leverage carefully and evaluate just how conservative certain assets really are, keeping in mind that many “safe” investments suffered in 2008.

4. Turn volatility into opportunity.

Volatility may provide great opportunities to implement a variety of investment and planning strategies, including:

- Reducing risk by diversifying low cost basis, concentrated stock holdings
- Transferring wealth with tax efficient strategies
- Managing the tax bite by capturing gains and losses
- Controlling risk through portfolio balancing

The appropriateness of these opportunities and other recommendations as well as their potential benefits is dependent on the unique circumstances of each investor.

In summary, the past decade has highlighted the importance of protecting and enhancing wealth, and that it is often a risky venture. Few people have mastered the nuances of investment strategy in the best of times, fewer still in times of great volatility where down side risk is that much greater.

This also points to the advantages of leveraging the services of an investment professional who can offer independent and un-conflicted advisory services, especially in an era of continued volatility. Taking these appropriate steps to manage through, and benefit from the volatility yet to come will help you achieve your investment goals.

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