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## Six Strategies for Managing Risk

by Steven Pomeranz, CFP

With a bull market on the charge since 1990, investors have reaped generous rewards. But many of those same investors watch apprehensively as the Dow Jones seesaws its way through some dramatic ups and downs. And quite a few financial analysts agree a downturn is inevitable. Understandably, thoughts turn increasingly from performance to the other side of the coin -- downside risk.

Let's face it. There's no way to completely avoid risk when you seek stock market returns. The trick is to be *rewarded* for taking that risk by learning how to manage risk at multiple levels. This will enhance your ability to reach your objectives.

What's on the financial horizon? Frankly, seeking a crystal ball that predicts the market's direction is like peering into a cup of tea leaves to predict an auto accident. It makes a lot more sense to make sure you have the right car insurance...and take extra precaution behind the wheel.

Sound investment strategies, backed by a sophisticated and disciplined implementation process, should deliver the same kind of sensible advantages as you "drive" towards your financial goals.

Here's a look at six strategies you can use to maximize the return and reduce "unrewarded" risk.

### **Strategy #1. Achieving Diversification: Keeping the Eggs in Different Baskets.**

The first step of risk management is achieving the appropriate level of diversification. Simply put, avoid keeping all your financial eggs in one basket.

Portfolios which are well diversified are broken down into asset classes (including stocks and bonds) and investment style (such as large cap growth and small cap value) -- as well as by country, currency and managers. Because of the inherent power of diversification, well constructed portfolios of assets in the right combination, should have a lower volatility than these assets might have individually.

### **Strategy #2. Incorporating the Global Perspective: A World of Risk Management Opportunity.**

It's my belief that diversification through international investing is one way of cushioning against bumps in the market. Because U.S. and overseas stocks don't move in sync, global investments can offset domestic losses if the U.S. market tumbles.

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For example, since the start of 1995, the volatility of the U.S. stock market was 11.2%, that of the developed international markets was 11.1%, and the volatility of the emerging markets was 13.7%. But a mix of 70% U.S. equities, 20% developed international equities, and 10% emerging market equities had a volatility of only 9.6% during that period. This may be an appropriate mix depending on your risk tolerance.

**Strategy #3. Rebalancing: Making Sure Some Baskets Don't Get Too Heavy.**

Over time, as asset classes grow at different rates, their proportions, or "weightings" drift away from the intended balance. This can increase the volatility of the overall portfolio.

To keep risk from ballooning along with the excess weightings, portfolio rebalancing readjusts assets to their target weightings, restoring the risk-management benefits of the original design. One can rebalance portfolios as often as necessary, but should take transaction costs and tax consequences into account first.

**Strategy #4. Style Neutrality: Because Investment "Styles" Come and Go.**

Sticking with a single investment style leads to inescapable volatility -- and risk -- because investment styles move in and out of favor. So to further reduce the volatility, seek to construct a portfolio to be style-neutral to and index like the Wilshire 5000. As a result, your equity portfolio will manage to reflect a degree of volatility similar to this broad market index.

**Strategy #5. Managing the Managers, and Investment Styles: It's All in the Mix.**

Each asset category should be comprised of different mutual fund money managers or index funds, each with their own specialist style. Look for funds or managers that stay consistent within their particular style and don't drift around from one style to the next.

For example, compare the similarity of a large cap manager's volatility to their style index. This should be a good indication that the manager is "sticking to his or her knitting".

**Strategy #6**

Keep an eye on your managers and the overall portfolio structure, but try not watch the daily fluctuations of your portfolio's value. This may lead you to overreacting when things get rough. Understand that you have invested for the long-term and the daily trials and tribulations of the market have little meaning in the big picture. Remember that you are investing in the growth of the global economy. As technology and political changes lead to higher standards of living around the world, your investments are targeted to participate in



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that growth.

### **In Summary**

Managing a portfolio should be like managing a successful business. One should manage financial risk intelligently. Like any well thought-out venture, a judicious exposure to risk can earn significantly enhanced returns. However, instead of passively accepting risk in the marketplace, we can use specific strategies to balance its reality with commensurate rewards.

By taking six steps...

- 1) Diversification
- 2) Globalization
- 3) Rebalancing
- 4) Constructing Style Neutrality
- 5) Creating the Right Mix of Managers
- 6) Monitoring your Progress

...one has a greater probability of reaping the rewards available in the marketplace today.