

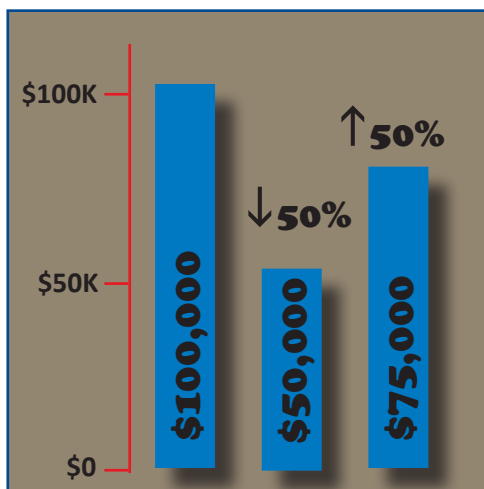
The Value of Risk Management in Investing

by Lee Anke, CEO

When investing, human nature tends to split people between two extremes: Most are so risk averse they crowd into risk-free, guaranteed instruments (such as bank CDs, fixed annuities, money market accounts, etc.). In keeping with the law of supply and demand, with demand so high, the cost of such instruments will be high – that cost takes the form of very low returns. The other extreme is investors who look for investments to get rich quick – they seek speculative returns. What such investors don't understand is that the old adage that "to earn a high return, you must take high risk" only applies to individual, speculative, investments. If you "spread your risk broadly" (diversify), you can, achieve reasonable returns with lower risk of loss. If you question that premise, think of the casinos in Las Vegas. If you roll the dice once, there's a very small chance that you could win a fortune (and the house loses one).

On the other hand, most of us realize that the odds are set to favor of the casino – if you roll the dice enough times, the casino is guaranteed to win, which means you are guaranteed to lose. Historically, the equities markets have shown roughly an average 9% bias to positive earnings (i.e., 9% annual growth since 1925). Of course, if you put all your money on a single stock, you may win big, or you may lose your shirt. But, if you "spread your risk" (diversify effectively), and if you are patient, you are more likely to be rewarded with positive returns on your portfolio. Notice that I emphasized the word, effectively. Managing downside risk is crucial. A big loss is devastating to an investment plan. At PIN, we like to say that losses are far more harmful than gains are beneficial.

**Diversification
has been
integrated into
the definition
of prudent
investing.¹**



Let's illustrate that point. Let's say you make an investment. In the first year (as happened in the 2008 bear market) you lose 50%. Fortunately, however, the next year the market takes you back up 50%. How have you done? Well, you are still down 25%! Why? It's easiest to understand when we talk in terms of dollars. As shown in the graphic to the left, had you begun with \$100,000 and lost 50%, you would have only \$50,000 left at the end of the year. But then you enjoy a 50% gain.

Unfortunately, you began the second year with only \$50,000, so 50% of \$50,000 is only \$25,000. At the end of the second year, that 50% gain only takes you back up to \$75,000. And, that's true whether you experience the loss first and the gain second, or the gain first and the loss second – in either case you'll end up with \$75,000. Here's the truth: to offset a 50% loss you must double your money – that's a 100% gain! How often do the markets double?

That brings us to the point of this article: We believe effective management of the risk of loss in an investment portfolio trumps all other factors in earning a higher long-term rate of return (not to mention the preservation of your capital). Let's illustrate that point graphically on the next page.

¹ Prefatory Note #4 to the Uniform Prudent Investor Act

We seek to bring financial peace of mind to our clients by prudently managing investment risk as well as return.

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In the chart to the right, you see three investment options tracked over roughly the past decade. The red line (the Standard & Poor's 500 Index¹) will serve as the speculative investor; the green line is the Prudent Investors Network Conservative Portfolio "risk-managed" account²; and the gray line is the Citi 6-Month CD Index³ (the guaranteed option favored by the strongly risk-averse crowd).

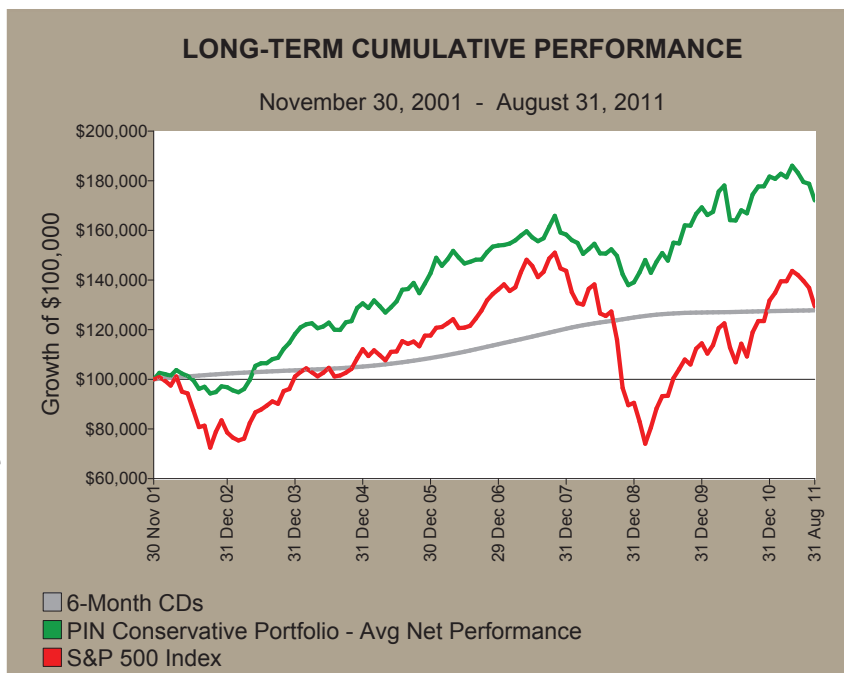
Notice how devastating that 50% loss was that the S&P 500 Index (the red line) took from late 2007 through early 2009. To recover from that loss, it needed to double (a gain of 100%) from that bear-market bottom. It never fully recovered. Before it could, the economic recovery stalled and, as of the writing of this article, it is still down 15% from its 2007 peak.

Now study the green line of the PIN Portfolio Account. Like the S&P, it peaked in late 2007, but lost only 17% before turning back up in January 2009. From its low point (December 31, 2008), it required only a 20% gain to break even with its prior high. It had already achieved that by the end of November 2009 and, as of the end of August 2011 it was 4% above its 2007 high. By avoiding the worst of the 2008 losses, it ended up with a 4% gain (since the 2007 high) versus the S&P's 15% loss over the same period.⁴

This was not an isolated event. In the late 2001 through late 2002 period, the PIN Conservative Portfolio dropped 6% versus the S&P's loss of 28%. The PIN Conservative Portfolio became profitable (i.e., crossed above the black line on the chart) by the end of April 2003, whereas it took the S&P another eight months to offset its losses.⁴

Finally, notice the long-term effect of consistently avoiding major losses. Since November 30, 2001 (to the present), the PIN Conservative Portfolio has enjoyed cumulative earnings of 79% while the S&P 500 has gained only 29% (in nearly a decade).⁴

How is this accomplished? Primarily through use of sophisticated analytical tools that enable truly effective diversification of an investment portfolio. There is a huge gulf between mere talk of diversification and possessing tools that test a portfolio's diversification and its risk of loss before losses occur.



In conclusion, management of investment risk and avoidance of loss is vastly more important to the protection of your principal and the achievement of desirable long-term investment returns than any other factor. Prudent investment management is the antithesis of striving for high returns by speculating and exposing your assets to high risk of loss.

¹ The Standard & Poor's 500 Index (S&P 500) is not a fund, it is a broad index of 500 leading U.S. stocks representing the overall market. Calculations assume dividends and capital gains are reinvested and do not include any expenses, including transaction and/or custodial charges, management fees, nor the impact of taxes. Expenses would have the effect of decreasing historical performance results. It is not possible to invest directly in an index.

² The PIN Conservative Portfolio began November 30, 2001. The charts track the actual results of PIN's first client in its "Conservative" Portfolio Model from November 30, 2001 through June 30, 2003; from July 1, 2003 to the present, it represents the average performance of all clients in the PIN Conservative Portfolio. PIN's performance includes dividends and is net of all fees, including management fees. Individual results will vary depending on factors such as date invested and cash added to or withdrawn from the account.

³ The Citigroup 6-Month Certificate of Deposit index is an unmanaged index of certificates of deposits maturing in six months. Citi reports returns net of expenses. The impact of taxes is not included. It is not possible to invest directly in an index.

⁴ It should be noted that past performance does not guarantee of future results. There are risks inherent with all investments and there is no assurance objectives will be achieved.