

## **RISK MANAGEMENT FOR INDIVIDUAL INVESTORS – BREAK OUT OF THE INSTITUTIONAL BOX**

Over the past decade, Conventional Wisdom within the Retail investment market has been increasingly encroached upon by the preaching of institutional consultants. Equity allocations are now expected to be stratified by capitalization and style boxes. Style drift screens require managers to stay within their box, and since managers are ultimately selected by their ability to beat other dwellers within the same box, they most often make the Faustian bargain of trading away investment liberties for compliance to the selection screens.

### Risk is in the Eye of the Beholder

Unfortunately, Retail clients have not always benefited by taking the institutional investment approach. Lest we forget, there are some fundamental differences between retail and institutional clients. Institutional investors have both the time horizon and asset scale to allow the statistics behind efficient frontier modeling to stabilize. Retail investors do not. Institutional investors' time horizon allows key assumption behind asset allocation modeling to play out, specifically normal distributions of returns, indifference to the sequencing of investment returns, and no material cashflows in or out of the portfolio.

While a bad year does not likely impair the strategic objectives of a large pension plan, it can have dangerous ramifications to an individual investor. Slavishly locking a client's portfolio into a series of style boxes supports the concept of asset allocation modeling, but removes an important tool for reducing downside market exposure for Retail investors. As we have learned this past month, strict asset allocation guidelines obligate investors to ride the roller coaster down as well as up. Therefore, retail investors need to think about risk controls in a fundamentally different manner than institutions.

The danger to Retail investors is that investment discipline has morphed into rigidity, and well intentioned or not, rigidity has forced myriad Retail investors into fully participating in the market declines over these past many months. There is an old saying that you never get hit by the bus you see coming. But over the past year there were a number of buses that were coming right down the middle of the street that still steamrolled a majority of investors. For example, it was not a state secret that the Financial sector was under severe pressure as early as last summer.

### Alpha through Risk Management

An example of a differentiated approach is an investment strategy that incorporates an aggressive individual client risk management philosophy into its DNA, and has been able to both outperform its benchmark while significantly reducing downside volatility. It has been available to select Private Wealth Clients since 2001, but is now being made available to a broader audience because it is the basis for a new index being introduced October 13, 2008 by F-Squared Investments, Inc. and published by the NASDAQ OMX - the AlphaSector Rotation Index (ticker ASRN). As the name implies, it achieves its goals by rotating

among the key sectors of the S&P 500 using a quantitative engine to determine buy and sell signals for each sector. But AlphaSector's success has come in no small part by rejecting several of the canons of current Conventional Wisdom.

Ironically, although ASRN has outperformed the S&P 500 by 374bp per year from April, 2001 through September 30, 2008<sup>1</sup>, several of its key investment guideposts were developed *for the purpose of defensive, risk management considerations*. It differs from current thinking in a few important areas:

1. It rejects the premise that the portfolio needs to be fully invested at all times.
2. It rejects the premise that portfolios need to be linked to market capitalization weighting schemes.
3. It rejects the premise that successful investment strategies need to be overly complicated.

CASH AS A SAFE HAVEN. AlphaSector utilizes a proprietary quantitative engine to generate a series of monthly buy and sell signals for each of 9 sectors of the S&P 500. Importantly, only positive signals translate to an investment in the portfolio – sectors with a neutral or negative signal are removed entirely from the portfolio. If a limited number of sectors receive a buy signal, then the remainder of the portfolio is invested in cash, up to and including a 100% cash position.

The role of cash is critical to AlphaSector's risk management. The benefits include an ability to significantly reduce risk levels while also providing for outperformance in periods of overall market weakness. This ability to use cash as a default position is one of the reasons that the strategy has delivered its outperformance while only incurring 72% of the risk of the S&P 500 since 2001<sup>1</sup>. For example, ASRN moved to a 75% cash position in late September, and on September 29, 2008 when the S&P 500 declined -8.8%, ASRN was down only -0.6%.<sup>1</sup>

RETURN POTENTIAL FROM SMALL SECTORS IS JUST AS VIABLE AS FROM LARGE SECTORS. The era of index-linked portfolio construction translates to a structural overweight to several sectors for any portfolio tied tightly to the S&P 500, such as Financials, Technology, and Industrials, and an underweight to sectors such as Utilities. However, research behind the ASRN has shown that the return potential from larger capitalization sectors is no greater than that for smaller cap sectors.

Most traditional index-sensitive equity strategies invest using min-max threshold bands for securities and sectors based upon the benchmark market capitalization weighting. The perversity of this model is that large sectors, such as Financials which traditionally has represented more than 15% of the S&P 500, can be set to a maximum *underweight* and still have a greater impact on the portfolio than Utilities at a maximum *overweight*. When you go through periods like 8/2007 – 7/2008 where the Financial sector was down -44.5%, any allocation to the sector will prove costly.

ASRN takes a different tact. Employing a binary investment model, sectors either have a zero weighting, or a full weighting. Full weighting reflects equal weighting among all sectors represented in the portfolio at that time. For example, from August, 2007, Financials had a 0% weighting within the portfolio, allowing AlphaSector to avoid any exposure to the massive decline in Financials since then. This absolute return/risk management benefit also accompanied a relative return gain of over 600bp in outperformance versus the S&P.

THERE IS POWER IN SIMPLICITY. ASRN is a long-only strategy that employs no leverage or shorting. There are never more than 10 securities in the portfolio at any time, and the portfolio is traded no more

frequently than monthly. The decisions for allocation into or out of a sector are based on a purely quantitative engine which translates to disciplined buy and sell decisions. Low cost products being made available that track the Index include broadly available SMAs, model-based overlay for mutual fund wrap programs, and in the future exchange traded funds and even principal protected versions.

### Back to the Future

In the 1970's, the saying went that "no one ever got fired by hiring IBM." The hiring firm was not always well served, but IBM's reputation was such that IT managers could never be second guessed for hiring them. Today, that same reputational safe haven seems to exist for advisor who cloak themselves in the institutional consultants' teachings, and lock their clients' assets in specific asset class boxes.

The most ironic part of the whole discussion, however, is that just as advisors are universally embracing the straightjacket of perfectly defined style and capitalization boxes, the institutions and their consultants are moving past them. *FUNDfire*, a daily news publication for the investment management industry reported on September 25, 2008 that "Foundations and endowments are in the midst of crafting a new approach to portfolio strategy" where "they divvy their portfolios into just a few broad categories, rather than a multitude of asset classes". The publication reported on September 29, 2008 that "Drexel University's endowment is building out an innovative investment portfolio that divides assets into fewer, broader silos. [It is] a portfolio organized not by specific traditional classes, but by how each type of asset behaves in the portfolio in terms of risk, returns and diversification."

It appears that the very institutions that act as role models for much of the thinking within the Retail market have already begun to rethink issues such as style boxes, style drift, and strict peer groupings in favor of a broader view of risk and returns. Retail clients would be well served to think through some of the same issues and free themselves from the style straightjacket.

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October, 2008

<sup>1</sup>Morningstar Direct, New Found Research, LLC, NASDAQ, and F-Squared Investments

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