

## RISK.....a four-letter word that deserves a real-world definition

At FiduciaryVest, we, like our competitors are focused on helping clients manage their investment risk. But, what do we mean when we discuss the topic?

After Harry Markowitz published his now 52-year-old paper, unveiling what is still called “Modern Portfolio Theory,” the investment world developed a fetish about the variability of returns earned over annual periods. One of the most important areas of Markowitz’s research was the impact of diversification (low correlation) on overall returns. But, as portfolio management grew exponentially during the past twenty years, most of the heat and light associated with the selection of managers was focused on the indicated volatility of *each managed portfolio*.

While portfolio managers in today’s style-specialty world fully understand that they are role players rather than single-source chieftains of their clients’ total investment programs, it is difficult to find evidence of that fact in the design of their products. Long ago, investment managers learned that, in order to field a saleable product, they had to generate return numbers which would deliver “acceptable” variability on a stand-alone basis, i.e., without regard to other managers’ portfolios that were being used by the same investor.

To be sure, some portion of portfolio volatility is simply trading noise. Unlike the legendary watched-pot that never boils, a group of common stocks can bubble over on any given market day, week or month, usually without any significance. But, it is a proven investing axiom that volatility abates in proportion to the passage of time. Yet, despite the past 30 years or so of advances in sophistication, efforts to gauge an investor’s tolerance for volatility have been under-whelming. While much of investor objective-setting is appropriately aimed at earning a particular level of return over some designated range of years, there is typically little attempt to understand that same investor’s “volatility horizon.” This result is not mere neglect in planning; more likely, most investors just fail to plant their feet firmly before launching an attempted touchdown pass.

Mr. Markowitz’s 1953 treatise has unfolded into a 21<sup>st</sup> Century investment industry that defines risk to be variability of returns, measured by their standard deviation. There is a major defect, though: the properties of standard deviation translate “risk” as being *both* the upside and downside variability of returns...in equal measure. Markowitz’s work was pioneering, but the word “computer” barely existed in 1953. He certainly did the best he could with the tools he had, but today we have no such excuse.

After observing less than effective efforts of consultants in the 1980s, those of us now at FiduciaryVest abandoned the consultant-driven, statistical approach to developing clients’ risk tolerance and asset allocation targets. Instead, we adopted a non-technical, interactive approach that allowed clients to rather precisely define their tolerance for investment risk in terms that are meaningful to them. There is no risk cookie-cutter. Any outcome that is directly affected by investment returns qualifies for inclusion in the risk-definition process. Despite its simplicity, this approach is actually more sophisticated than the traditional statistical definition of risk.

The simplicity features permit a description of our approach in few words, as follows:

- *Each client has importantly unique and pertinent aspects that should play a role in assessment of that client’s risk tolerance and the development of its asset allocation; therefore,*
- ***If we define “risk” as exposure to Unacceptable Outcome(s), then***
  1. *Risk tolerance is measured in real-world terms that are client-specific,*
  2. *Statistical definition of risk is unnecessary (i.e., standard deviation of the expected average of one-year returns), and*
  3. *Risk management conclusions are automatically client-specific, because only that client can specify what is “unacceptable” to them; and then*
  4. *Probability-based models can be constructed to produce asset allocations with high probability to attain client goals for return, along with low probability for Unacceptable Outcomes at the client’s selected time horizon.\**

*\*This modeling approach can also be used to create structure and allocations among investment managers in a client’s program.*