A Risk Conversation Near New Market Highs

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Many advisors and clients have risk conversations after the market has taken a hit, the portfolio has sustained losses and the client is nervous. Advisors at this point become coaches to help talk their clients down from the ledge to avoid knee-jerk short-term reactions driven by fear. Locking in steep losses and then watching the market recover with the client sitting on the sidelines is a bad outcome on many levels but it certainly does not advance the client's financials goals and does not strengthen the client/advisor relationship. With the stock market probing new highs while measures of volatility are at historical lows, perhaps a more proactive approach to that risk conversation could be timely.

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Introduction

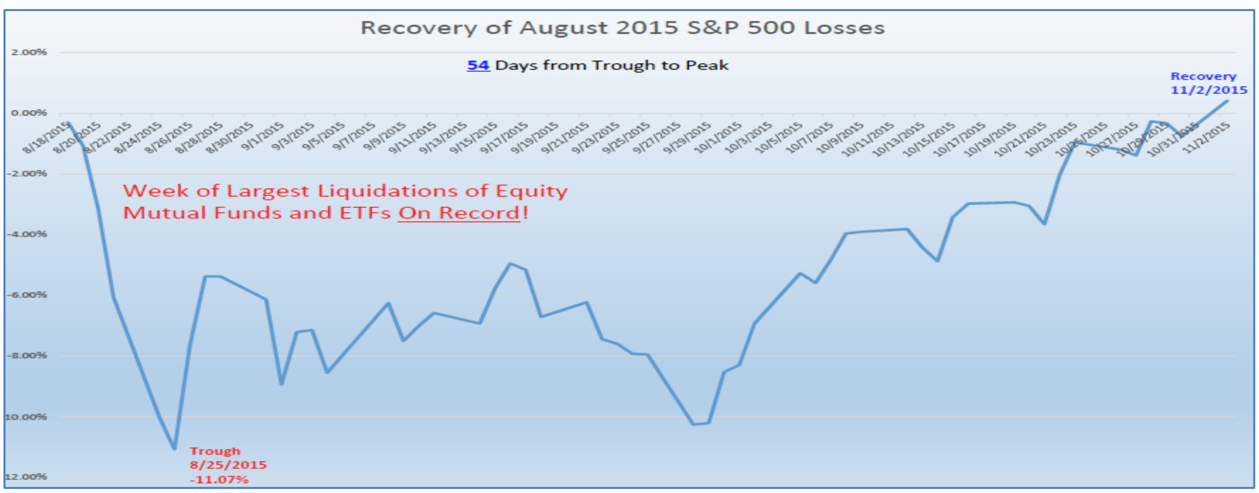
After more than three decades of evaluating professional traders and portfolio managers, I will begin with my view of the basics.

1) Bull and Bear markets come and go without ringing a bell.

2) Managing the impact of fear and greed on client behavior is a major challenge for financial advisors. Investors, without effective coaching, can make bad short-term decisions with profound long-term implications for their financial and life goals.

3) There is no *Silver Bullet* for modeling risk. Each risk modeling methodology can make assumptions that may not hold true at the worst possible time. I view *humility* as the most important survival skill when modeling risk. We go into the effort with the premise that we don't know what we don't know.

4) Paraphrasing Voltaire, "*Perfection is the enemy of good*." In other words, just because modeling risk is imperfect, does not absolve us of the duty to try. The perspective gained from the effort can help provide context for making more effective decisions – including doing nothing – which can sometimes be the right answer during periods of market stress.



The Problem

The chart above is a good example of investors making decisions that don't advance their long-term interests.

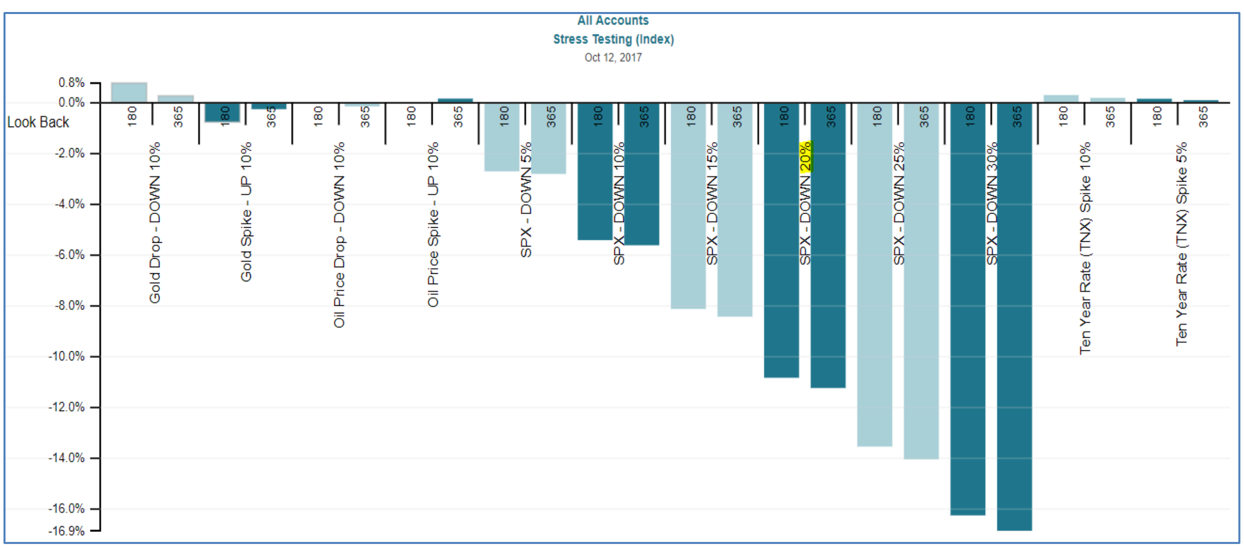
In August 2015, China sneezed and the US equity markets briefly caught a cold. The S&P 500 dropped 11% in a few days. That week also logged the largest recorded investor liquidations of equity mutual funds and ETFs on record (see "*Total Capitulation*" article here). Investors dumped stocks in huge numbers, likely against the advice of their financial advisors. Right after that mini-panic, the S&P 500 fully recovered the losses in only fifty-four (54) days. The market then resumed its march upward to today's post-election highs. Locking in steep losses during a market downturn and then missing out a subsequent recovery can inflict life changing consequences when investors fail to meet their goals for retirement income.

Stepping away from the risk conversation for a moment, I want to briefly touch on the "Robo" vs. "Real Advisor" debate. The common wisdom is that the compounded impact of lower Robo fees will produce better long-term results. In a perfect world where investors always control their emotions, that math could be true. The reality however is that we do not live in a perfect world and investors are not always rational creatures. In the example above, if a real living and breathing advisor can coach an investor out of locking in sharp losses and missing out on subsequent gains, the difference in the long-term outcome for that investor could easily dwarf the impact of the discounted Robo fees - for *decades*.
I make this point not to promote active management but to help investors consider this question with a more nuanced perspective than a simple comparison of fees.

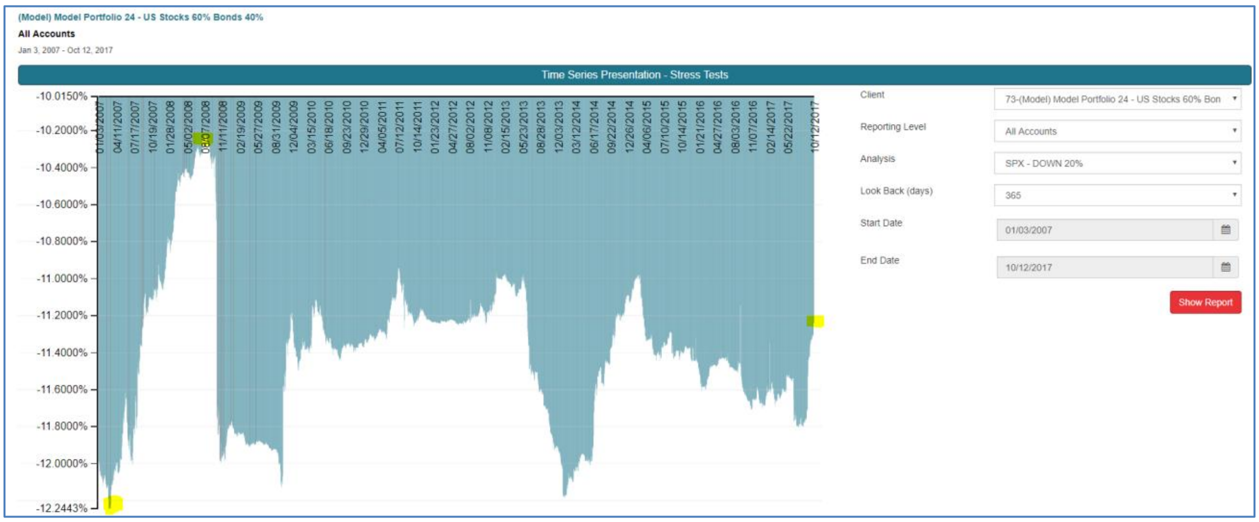
The Conversation

The focus of this paper is the risk conversation between a ***non-quant*** advisor and a ***non-quant*** client. The "*non-quant"* qualifier is important because if the client does not understand what the advisor is sharing, then that investor's buy-in and the targeted positive behavior modifications are also at risk.

An example may be useful to illustrate an advisor/investor conversation about the impact of a potential market correction on that investor's portfolio. In the example below, we are shocking a diversified portfolio (60% stocks / 40% bonds) to model its potential behavior under various stock market, commodity and interest rate shocks. Focusing on the middle third of the chart, the 20% drop in the S&P 500 index, we can project that this portfolio is likely to lose somewhere between 10.8% and 11.2% depending on the lookback period we use for the calculations. This chart is helpful because it begins to illustrate (not with absolute precision of course) the potential magnitude of downside outcomes associated with various scenarios.



I believe that a key element to helping investors stay calm during periods of market stress is providing them with context. A fair question about any risk projection relates to the stability of that portfolio's risk profile for that scenario over time. For example, if today we are projecting a potential portfolio downside of 11.2% in the event of a 20% market drop, how stable is that projection? The chart below begins to provide those insights.



The chart above shows the range through which this projection has fluctuated since January 3, 2007. This period includes the financial crisis. We can see that today's projection is of -11.2% is well within the range of the best value of approximately -10.2% and the worst value of about -12.2%. In other words, today's projection is well within a range of about 4% which included a period of severe market stress. This context is incredibly valuable because it helps a client understand that their current risk profile is not an outlier and reinforces confidence in their original financial plan.

The time series chart above can fluctuate for many reasons including changes in portfolio mix over time or a change in how one or more of the individual portfolio holdings correlate to the index being shocked. These changes can be gradual and sneak up on both the advisor and the investor and – again – no one rings a bell.

A robust risk oversight process would include automated nightly processing that would trigger pre-set risk alerts when a mismatch is identified between the *current* risks embedded in the client portfolio and that individual client's *current* risk tolerance.

Conclusions

1) We are probing post-election stock market highs after a very long bull market that began in March 2009. That does not mean that a large correction is imminent but a thoughtfully structured risk conversation with clients could be very timely – and certainly cannot hurt.

2) Advisors frequently wait to seriously discuss risk with clients until the inevitable market correction triggers portfolio losses. This discussion unfortunately occurs after the client is already anxious and not a paragon of rationality. This “Stay the Course” conversation is usually grounded in a reminder about the benefits of diversification and the long-term performance of equities. Unfortunately, when the clients are already stressed and fearful, this argument may or may not resonate with them at the level required to avoid unfortunate knee-jerk reactions.

3) A thoughtful and structured risk conversation should occur regularly – preferably well in advance of periods of market stress. Ideally, during quarterly or annual planning meetings, the advisor can plant the seeds about their daily risk-oversight process that can help clients stay committed to their long-term investment plans.

4) As demonstrated above, automated daily risk analytics can provide both the data and the reporting tools (including customized and fully automated risk alerts) to support a ***two-way*** risk conversation between a ***non-quant*** advisor and a ***non-quant*** client.

5) If the risk conversations are regular, intuitive, educational and actionable, the context provided to clients over time, should reduce the probability of bad decision-making based on fear instead of facts.

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