

# Yikes! I'm afraid!

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*You want to invest, but you don't "want to take any risk." Is that possible? This seminar will answer that question and help you to cautiously side-step the perils of poor planning.*

## I. Understanding Risk

### A. Definition

= the possibility that an investment's actual return will be different than anticipated and that some or all of the original investment will be lost

### B. Types of Risk

#### 1. Systematic (Pure) Risk

- **Unavoidable**
- Either event and resulting loss occurs, or not



Investors are often at the mercy of events over which they have no control but which can affect the prices of virtually all securities. Hence, systematic risk is also known as Market Risk and can never be eliminated entirely; only *minimized* through portfolio diversification.

#### 2. Non-systematic (Business) Risk

- Specific to a particular industry or enterprise
- Not an all-or-none proposition



## II. Specific Risks [Systematic: A – G; Non-systematic: H – N]

- A. Market—security prices are **universally affected** by broad-sweeping occurrences. *Despite inherently sound fundamentals, Home Depot's (HD) stock price dropped precipitously by 22.5% from \$20/sh to \$15.50 on October 19<sup>th</sup>, 1987 (Crash Monday)!*
- B. Legislative—stock prices are negatively impacted by **unfavorable laws**. *Embroided in litigation which culminated with the eventual passage of the Tobacco Settlement Agreement in 1998, Philip Morris (MO) saw its stock price deteriorate from a split-adjusted price of about \$48/sh to roughly \$16/sh in early 2000.*
- C. Political—investments impacted by sudden, unanticipated shifts in **governmental policies**. *War almost always has an affect on all financial markets. Marked by a period*

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*of uncertainty prior to the start of aggressions, markets typically stagnate or even falter, but recover once hostilities begin. On March 17<sup>th</sup>, 2003 the Dow Jones Industrial Index (DJIA) rose an impressive 241 points with the start of Gulf War II.*

- D. Global—U.S. stocks are often adversely affected by **world events**. *The Asian crisis was initially attributable to poor investments of foreign capital in marginal industries and a lack of governmental controls in Thailand, but quickly spread throughout the region. Political instability in Indonesia, a weakening economy in Japan and finally the 95% devaluation of the Korean Won led to a crisis of confidence which contagiously spread across the Pacific, leading to a 13% drop of the Dow from July to October 1997.*
- E. Currency—as money circulating in one country is **devalued** relative to other mediums of exchange, dire economic consequences often ensue. *Hoping to revive its faltering economy, the Russian government implemented a drastic devaluation of its ruble on August 17<sup>th</sup>, 1998. The U.S. was heavily dependent upon Russia which had historically absorbed 6% of total U.S. poultry exports. With the ruble now worth one-third less, Russians could no longer afford to buy American poultry. This, in turn, initiated a prolonged decline of Tyson Foods (TSN) which saw its stock price slide from about \$24/sh in late 1998 to only \$9/sh in early 2000.*
- F. Inflationary—as the **value of the dollar declines**, consumers lose buying power. *The Consumer Price Index (CPI) is published monthly by the U.S. Bureau of Labor Statistics and measures price changes of a fixed basket of goods. Each month, the cost of these items is computed and then compared to the previous month's cost to determine if prices are trending upward or downward. For example, the price of a loaf of white bread has risen steadily from \$0.54 in 1984 to \$1.04 in 2003—a 93% increase.*
- G. Interest Rate—**changing interest rates** adversely affect the value of portfolio assets. *Since interest rates throughout the economy are interdependent, each rate is affected if the Federal Reserve (FRB) Chairman proclaims a change in the Discount Rate. Corresponding increases can be witnessed in the Fed Funds, Prime Rate, bank and mortgage rates; even credit card rates. An investor holding a 30-year corporate bond with a once-attractive rate of 5% might now wish to replace his investment with a higher-yielding alternative. However, to sell his bond, he would have to attract buyers by lowering his price. Thus, there is an inverse relationship between bond prices and yields.*

Y↑ P↓

*Once a bond is issued, the coupon (nominal yield) remains fixed for the duration and is thus, unresponsive to any interest rate changes that may otherwise occur in the economy. Since the yield cannot change, the bond price must fluctuate to make the bond more attractive and marketable.*

**LT prices fluctuate more than ST prices  
ST rates fluctuate more than LT rates**

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The following table illustrates the effect of changing interest rates on bonds with maturities of 1, 10, and 30 years:

Rate Change	Price of 1-year Bond	Price of 10-year Bond	Price of 30-year Bond
If interest rates fall by 1%	\$1009.63 + 0.963%	\$1077.90 + 7.790%	\$1154.54 + 15.454%
If interest rates rise by 1%	\$990.50 - 0.950%	\$928.90 - 7.110%	\$875.30 - 12.470%

Whereas, the interest rate of a short-term bond can be adjusted to prevailing rates each time the instrument matures.

- H. Business—a company’s stock price is affected by such **company specific factors** as poor management, labor unrest, competition, product obsolescence, and litigation. *Styles on Video (SOV)—now defunct—banked entirely on its one product. Once an innovative idea, technology soon surpassed that which the company offered and anyone with access to a computer could visualize and select differing hairstyles without relying upon SOV’s outmoded video camera installations in specialized salons. The stock price rose meteorically to more than \$18/sh after it came to market in April 1993 at a split-adjusted price of \$4/sh and quickly began its slide to unrecoverable depths by December 1994—it now “trades” at 1/100<sup>th</sup> of a cent!*
- I. Underwriting—**investment bankers assume the risk** that a new issue of securities may not be bought by the public and/or that the market price will drop after the offering. *Wired Ventures, Inc.—the publisher of the high-tech magazine Wired—turned to the prestigious underwriting firm of Goldman Sachs during the Initial Public Offering (IPO) heyday of 1996 in hopes of raising capital. The investment bankers twice availed themselves of the market-out clause, proclaiming “adverse market conditions” despite the fact that a record number of IPOs (768!) successfully raised \$38.8 billion during the same period. In fact, the failure of the IPO had less to do with market conditions than with overvaluation of the stock (with a Price-to-Sales ratio of 18 compared to an industry average of 3 for publishing companies) and the selection of an underwriter who was not internet-savvy. In the end, the company was forced to seek out private financing before folding up shop.*
- J. Financial (Credit)—exposure due to **corporate bankruptcy and default**. *Shares of American Airlines (AMR) rallied in April 2003 as the company dodged the bankruptcy bullet. The stock price rallied from \$1.58/sh to \$4.65 on news of union wage concessions.*
- K. Loss of Principal—**capital loss** can be eliminated through use of insurance. *Although a security could decline in value and even become worthless under certain circumstances, this risk is eliminated when choosing an investment that is backed by the Federal Deposit Insurance Corporation (FDIC) or another insurance company. For example, investors purchasing annuity contracts have assurance that their investment cannot decline below the initial premium outlay.*
- L. Liquidity—the possibility that a security may **not be convertible to or redeemable for cash** without a substantial price detriment. *Money market funds, as well as checking and savings accounts allow for instant conversion to cash and in fact frequently provide*

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*investors with immediate access via check-writing or ATM privileges. Many other short-term instruments are considered to be liquid, as the time-frame for conversion to cash is almost instantaneous and without penalty, including Series EE bonds and T-Bills. On the other hand, banks assess early withdrawal penalties on CDs.*

- M. Pre-payment (Re-investment)—does not allow an investor to capture equally favorable returns on new investments when forced to replace previously-held securities which have been **redeemed prior to maturity**. *Municipalities typically issue long-term debt obligations to fund their infrastructure. Forced to borrow at the prevailing interest rates, the issuers must offer coupons which are competitive with other securities. During the Carter years, interest rates on high-grade municipal bonds (munis) soared to over 11%! Afraid to be committed to these exorbitant rates, many issuers offered callable bonds which could be redeemed early at the discretion of the issuer. Although they often had to pay a premium to the investor, the issuers readily called their bonds once interest rates declined and it became favorable to float new bonds at lower rates. Investors, however, soon suffered the consequences. At the mercy of issuers and unable to control the timing of the cash flow, investors would receive redemption proceeds and then be forced to seek out new investments which could never match the returns to which they had become accustomed.*
- N. Actuarial—**insurance underwriters assume the risk of an unpredictable event** in exchange for receipt of a premium. *Although death is of course predictable, the timing of its occurrence is not. In the case of life insurance, the company is gambling that the insured will live beyond his predicted life expectancy, thereby giving the insurer ample time to invest the policy premiums before making an eventual payout to the beneficiary. The company loses the bet when the insured dies prematurely.*

### III. Tools to Measure Risk

- Standard Deviation—the statistical measure of the degree to which a single value in a probability distribution might vary from the norm. Investors can use standard deviation to project the possible range and probability of future occurrences.
- R-Squared--represents the correlation between an investment and that of a market index, which is always assigned an  $R^2$  of 100.
- Sharpe Ratio—attempts to calculate the amount of reward per unit of risk as measured against T-bill rates of return. The higher the ratio, the better.
- Morningstar Style Box—a standardized system used to compare equity mutual funds. And identify risk patterns. Funds toward the upper left-hand corner tend to have the mildest risk scores while funds at the bottom right are the riskiest.
- Omega Ratio—measures the ratio of investments gains against losses. If gains equal losses, the ratio will be 1. Ratios greater than 1 indicate a high probability of achieving positive returns.

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- Economic Cycle—economists subscribe to various schools of thought, including Keynesian, Monetarist, Supply-side and Laissez-faire economics, but all agree that the economy is cyclical. Periods of prosperity are followed by periods of recession which are inevitably followed again by renewed periods of prosperity.
- Yield Curve—captures the overall movement of interest rates.

#### IV. Risk Management

- A. Risk Avoidance—if an individual is free to make a choice, avoidance eliminates all possible exposure but also precludes any possibility of gain. The proverb “**Nothing ventured, nothing gained**” holds true. Often risk avoidance translates into inactivity.



- B. Risk Reduction—mitigation is almost always possible and usually cost effective. This strategy involves making lifestyle choices such as participation in a driver education program, maintenance of a healthy diet and periodic home inspections to detect infestations before termites have chewed through the timbers.

Investors may elect to do **preventative maintenance** by periodically reviewing their portfolios and making necessary allocation adjustments when fundamental or technical indicators dictate. Shifting from bonds to stock as the market is poised to recover, might offer the investor significant growth opportunities while reducing his exposure to interest-rate sensitive securities.

- C. Loss Reduction—an attempt to diminish the severity and lessen the frequency of loss occurrence.

An investor may choose to **take pro-active steps** to reduce risk by identifying the maximum exposure he is willing to assume on a particular stock and then placing a stop-loss order. Say that the investor has purchased 100 shares of XYZ at \$60/share and has decided that he would like to lose no more than 10% on his investment. He could place an open order with his broker asking that the stock be kept as long as it trends upward, but that it be sold if the price drops to \$54 or less. This order will then be automatically executed if it becomes necessary. Although the investor has taken measures to reduce his loss if damage occurs, he will forfeit potential future gains, should the stock recover after only a momentary response to unfavorable news.

- D. Risk Maintenance—occurs when individuals simply decide to **assume risks themselves**. It should not be done out of ignorance, but rather based upon a decision which is conscious and calculated.

Investors seeking to employ this strategy must, of course, be able to absorb the losses to which they are potentially exposed and must set aside funds for a rainy day. For example, most sound financial plans call for the maintenance of an emergency reserve of cash or cash equivalents equal to 3 to 6 times the investor’s typical monthly expenditures so that the cash in the bank can tide him over until a new job is found or his disability insurance policy kicks in. Unfortunately, if the investor has misjudged the

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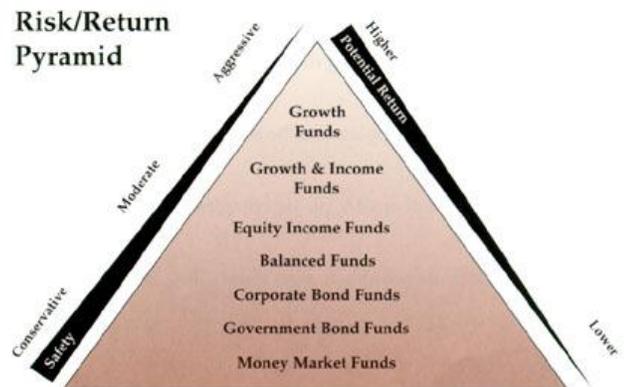
severity of the potential setback or the frequency with which the misfortunes may occur, his risk exposure may become unmanageable.

- E. Risk Transference—mitigate risk by **transferring its assumption to a third party**. This naturally will entail significant costs, as the person assuming the responsibility will want to be compensated for his exposure.

An investor may choose to hedge his bet by going long and short at the same time. When buying a security, he hopes that the market will rise so that he may later sell his investment at a profit. A short-seller, on the other hand, hopes to profit from a decline in the market by selling borrowed securities at current market prices and then covering his obligation later by purchasing the securities at lower prices.

#### V. Risk versus Reward

1. Cash and equivalents—provide safety and liquidity—include checking, savings and money market accounts, short-term CDs, and life insurance policy cash values. **CONSIDER:** Maturities, early withdrawal penalties, financial strength of the institution, and FDIC or SIPC coverage.
2. Fixed-income securities—provide current income, but have low appreciation potential—include fixed annuities, corporate and municipal bonds, government securities, collateralized mortgage obligations, preferred stock, and unit investment trusts. **CONSIDER:** Maturities, ratings, coupons and yields-to-maturity, call provisions, and conversion options.
3. Equities—provide growth opportunities—include income and growth stocks, speculative and new issues, variable annuities, and index funds. **CONSIDER:** Dividend yields, P/E ratios, liquidity, volatility, industry trends, timing, and taxation.
4. Real Estate—provides leverage and depreciation deductions, but requires ongoing management and creates liability exposure—includes raw land, rental and commercial property, construction, mortgages, REITs, and limited partnerships. **CONSIDER:** Location, marketability, appreciation potential, cash flow, occupancy rates, and debt-to-asset and debt-to-revenue ratios.
5. Hard Assets—provide inflation hedge and tangible satisfaction—include commodities and collectibles. **CONSIDER:** Authenticity, appraisals, cost of purchase and commissions, illiquidity, personal satisfaction.
6. Other assets could include oil and gas ventures, equipment leasing, options, rights, warrants, futures, and other derivatives. **CONSIDER:** Fundamental risks, diversification, management expertise, marketability, time value, and loss potential.



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