CEDARWINDS
INVESTMENT MANAGEMENT

March 2009

REVISITING RISK

"Over time, markets will do extraordinary, even bizarre, things. A single, big mistake could wipe out a long string of successes. Certain perils that lurk in investment strategies cannot be spotted by use of the models commonly employed today by financial institutions." --Warren Buffett

Introduction

The recent investment environment has been, in a word, brutal. The damage has been heavy, both financially and psychologically, to all investors from the smallest IRA account holder to the largest, most sophisticated college endowment fund. In light of the 24/7 media coverage dedicated to the faltering global economy, it is not surprising that the topic of risk management has become a daily obsession.

First, let's quantify the damage. Since election day, November 4th, U.S. stocks have lost $3.8 trillion in value. Since the economic stimulus package was initially passed on January 28th, U.S. stocks are down $2.3 trillion. Since the stock market peaked October 9, 2007, U.S. equities have lost $11.1 trillion in value. The S&P 500 Index is already down 24% this year compared with the 38% loss for all of last year. Similarly, the international and emerging markets have been negative in lockstep with the domestic equity markets. Recent estimates are that the rout of stock markets around the globe has wiped out as much as 45% of the world's wealth. And the general decline seems to have accelerated over the first trading days of March despite the significant one day rally on March 10th (a positive omen that the bottom is near?).

In terms of what is being done about this, it is becoming increasingly clear that the economic stimulus (i.e., spending) package orchestrated by the Obama administration will take longer to implement and cost more, perhaps much more, than had been initially thought. Meanwhile, the daily business news is grim: auto companies are on life support, unemployment is rising, the housing crisis is not improving, consumer confidence is falling, corporate earnings are in the tank, companies are cutting or eliminating dividends, the banking system is broken, etc.

By any measure, you have to go back to the depths of the Great Depression 80 years ago to get a true sense of the economic difficulties we are currently experiencing in this country. And because these problems have infected the entire global financial system, this market meltdown is truly an unprecedented, epochal event. But it is not only the pandemic nature of the financial carnage, it is also the speed of the descent that has been so alarming.

While it is probably safe to say that this is not financial Armageddon, make no mistake about it—this is a *very* big deal. No one saw this coming in terms of the magnitude or scope of the devastation. The sheer complexity of issues and the fact that there is not a coordinated, battle-tested, off-the-shelf set of solutions to our global economic woes imply that governments, consumers, businesses, institutions and all markets will be dealing with these problems for years to come.

If all of this causes you to start moving to the nearest open window, stop, take a deep breath and let's revisit the topic of risk. In the context of the most challenging investment environment we've faced in decades, the following Q&A format is intended to highlight our risk management philosophy and reinforce the approach we are taking with respect to managing the risk process.

We also provide some perspective on what the markets seem to be telling us and what may be expected moving forward.

Has your risk management <u>philosophy</u> changed as a result of the current bear market?

The short answer is no, our core philosophy has not changed. In fact, the current global market problems have merely served to reinforce our fundamental belief that a disciplined, indexed approach to global diversification across multiple asset classes is the key to achieving predictable risk-return relationships while reducing portfolio volatility. One only has to consider the damage that some investors have experienced by having concentrated positions in, for example, the financial services sector where many stocks have lost over 90% in value during the last year.

Has your <u>definition of risk</u> changed as a result of the bear market?

No. Readers of earlier editions of our firm's newsletters may recall that we define risk in terms of two separate but related elements—*investment risk* and *portfolio risk*.

We refer to *investment risk* in general terms as the risk of not ending up with the amount of money investors theoretically could and should have at a future date based upon the effective application of historical risk-return relationships. We frame out the definition of *portfolio risk* in more specific, technical terms such as standard deviation, correlation coefficients and other assorted volatility measures.

Has your <u>risk management process</u> changed as a result of the bear market?

Yes, we have slightly modified the investment process we use in our general investment management activities. The changes we have made are marginal and are not at the core of our risk management process.

To put these modifications in perspective, it is helpful to revisit how we operate in terms of our core risk management process. Recall that our process is designed to create a predictable risk-return relationship across the model portfolios we have developed. Our process continues to be fact-based, mathematically-centered and rules-driven. We use quantified standards for measuring volatility and design risk-return relationships into our model portfolios. We believe that understanding and controlling volatility is the key to protecting and enhancing longer term investment value.

Our primary strategy of dampening volatility and reducing overall portfolio risk is achieved through a process of global diversification and disciplined asset allocation. The risk profile of our various model portfolios depends on the relative concentration of underlying domestic, international and emerging markets equity funds along with how much fixed income (bonds) is in each portfolio. There is a slight asset class tilt to smaller stocks that are value oriented as research clearly demonstrates the benefit of this focus over time compared with large or growth oriented companies.

We use fixed income allocations as the primary means to dampen performance volatility—the higher the fixed income allocation percentage in a portfolio, the lower the volatility. The processes built into our asset allocation methodology have historically resulted in performance outcomes that have demonstrated a high level of predictability in terms of relative risk-return correlations.

The recent modifications we have made to our process are a function of how we have interpreted the market's unprecedented volatility. Although our investment style is rules-driven, we use our best judgment before invoking those rules. For example, before the markets began to really struggle last October, we would normally invest any new deposits immediately upon receipt and apply them to the specific asset allocation model used in each client portfolio. In effect, this was based on our belief that market timing is not a strategy that makes sense for long-term investors. We also strongly advocate dollar cost averaging as a tool to take advantage of market volatility. However, the sustained strength of the current headwinds has caused us to delay putting new money to work, or to phase in new money over a number of months, in the belief that there is a certain momentum to the negative trend that we have experienced of late.

Likewise, more recently we have resisted rebalancing accounts having fixed income and equity exposure back to their original model percentage allocations due to the perceived momentum of falling equity prices. Rebalancing is a tool of discipline but it does not make sense to rebalance when everything seems to be going down.

For example, an account having an original 70% equity/30% fixed income allocation might have migrated to a more conservative 55% equity/45% fixed income allocation due to falling equity markets. In normal circumstances, we would have rebalanced the account back to the original model once the equity/fixed percentage relationship deviated by more than 5% from the model allocation—in this instance at 65% equity/35% fixed income. However, the recent market decline has created enough uncertainty to cause us to postpone rebalancing most accounts until the markets become more stable.

*** NOTE: For more information concerning our core process, please visit the Newsletter tab on our website (www.cedarwinds.com) to find links to a series of articles describing how we manage the risk-return relationship.**

Is there anything about the bear market which has changed your attitude about how you manage your risk process?

Most definitely! We are far more introspective and analytical in terms of what we do every day. Given recent events, we constantly ask the question, "What can or should we be doing now that is different than what has worked in the past?" A great deal of energy has been dedicated to reviewing current market dynamics, talking with other investment professionals, and comparing historical performance patterns in search of clues to address how to manage through the current uncertainties in the markets.

Scores of articles have been written about risk by authoritative, well-respected academic think tanks, financial journalists, investment consultants, fund companies, investment advisors, and individual investors. We don't want to get too technical here, but basic investment axioms—the "holy grail" of our business model: Modern Portfolio Theory, Efficient Markets Hypothesis, Random Walk Theory, normal distributions and mean-reversion standards—are under rigorous scrutiny.

Indeed, some industry experts are now questioning whether diversification is an effective tool for those seeking to minimize risk in a volatile market. For example, based on the fact that all markets—domestic, international and emerging—have fallen off a cliff since October 2007, how can we say that diversification works? And it's not just the US and non-US markets that have punished investors. Diversification by style (growth versus value), size (large cap versus small cap), and across major sectors of the fixed income markets have all exhibited the same undesirable property—greater correlation in down markets than in up markets. In terms of the global diversification strategy we advocate, this technique has failed to protect investors in the down market precisely when it was needed the most.

It is times like this that cause everyone to question the fundamental precepts of how the industry manages risk. Frankly, we think this is healthy as it reflects an industry that needs to question the status quo and challenge assumptions in light of the performance duress all investors have experienced.

Not surprisingly, there are all sorts of market timing strategies, relative valuation strategies, hedging programs using index options and alternative asset class investment programs that advertise how their approaches have benefitted investors in the current bear market. The implication is that they are going to help the investor time the market and their seers will somehow help ascertain when to jump between stocks, bonds and cash based on what they see in their crystal ball. Playing the “Is now a good time to invest?” game, no matter how it gets dressed up, is market timing. And our belief is that market timing is a loser’s game.

While we remain unconditionally committed to our core strategy of global asset allocation using a “buy-hold-rebalance” methodology as the most effective way to manage risk, we also recognize the dynamics of change at work. As a result, we are constantly on the lookout for *proven, risk-appropriate and cost-effective* investment tools and analytical methods to help protect portfolios when the market falls off the proverbial cliff. It is a challenge the entire industry is struggling with—and unfortunately there are no silver bullets. However, we will continue to aggressively search for reasonable alternatives as part of our mission to help clients systematically build and preserve wealth, especially in times of high volatility.

What is the biggest risk you see in the market today?

Our answer is simple—it is *political risk*. Generally, political risk refers to the complications investors may face as a result of political decisions.

Perhaps the greatest irony of the current market mess is that this term is usually associated with smaller, emerging countries with unstable governments run by dictators or their military regimes, where there is the potential for social unrest.

The economic policies in the U.S. have moved away from traditional market-driven decisions to massive government-led bailouts, trillion dollar spending programs and proposed tax hikes directed by Washington bureaucrats. Our view is that there is very significant risk to all investors that these programs, if they do not work, will cripple the U.S. and global markets for years to come.

Will the spending and tax initiatives proposed by the Obama administration and supported by the democratic majority in Congress manage to revive the American economy? It seems the anticipated date for such a revival keeps getting pushed further out. Meanwhile, the attempt is causing no end of pain now. As we have said many times before, the markets do not do well in periods of extreme uncertainty—it breeds fear, panic and indiscriminate selling. Ultimately, this scenario will reverse course, but not before it tests everyone on the way down.

Are you advising clients to stay the course with their long-term asset allocation plans, or do you think the financial markets have fundamentally changed, therefore requiring a different approach to asset allocation?

Our analysis is that markets have not fundamentally changed despite all the recent dislocation. We continue to advise clients to avoid becoming too emotional about portfolio performance and to resist the urge of making wholesale changes to their asset allocation in periods of extreme duress. Prices can be a roller coaster ride in the short-term; in the long-term, markets tend to provide returns in balance with the risks.

Although there may be debate about how we define short-term versus long-term, the underlying theme remains the same. Our best advice is to think carefully about your risk tolerance in light of current market conditions. If you are losing sleep because you are worried sick about your portfolio, and you are on the verge of making an emotional decision to sell it all, then reduce your equity allocation by 10%. Give that some time. If you are still having a difficult time emotionally, reduce your equity allocation by another 10%. The portfolio has an appropriate level of risk when you are able to think clearly. Once you find this level of risk, stay there, even when the market recovers.

With the major market indices off more than 50% since October 2007, along with all the economic bad news here and abroad, do you see any significant additional downside in the near future?

Could the markets go down another 20% from here? Perhaps, but the downside odds have greatly diminished since the end of 2008. Unfortunately, we do not see any single big event that will turn things around.

Whether their outlook is bleak or hopeful, the experts seem to agree on one thing: The most serious threat to the economy is rising unemployment. The most important business dynamic that works against job creation in an economy dropping this quickly is the fact that every worker is a consumer. Because consumer confidence drives spending, layoffs are a vicious cycle that undermines economic expansion. The risk to long-term recovery is that all the stimulus package will do is to provide only a brief reprieve. The longer that consumer spending languishes, the harder it is to see the markets revert to their longer term growth trend anytime soon. Ultimately, this will occur but it is the timing that is so problematic.

Wouldn't I be better off in cash now and wait to invest when the markets turn?

This is the hardest question of all. We find it very difficult to remain stoic, even defiant, in the face of stomach-churning, rapidly declining markets. Yet, as long-term investors, waving the white flag, admitting defeat, liquidating all holdings and perhaps moving everything to gold in an act of final capitulation is not a terribly appealing alternative.

When markets decline, especially over several months or even years, it's only natural to try to limit losses. It's very hard to sit tight. Yet, most of the time, sitting tight is the best thing to do because taking action is usually tantamount to trying to time the market. Bitter experience has shown market timing to be a losing strategy, even for professional investors. We have struggled with this question big time going back to last October 2008, when the markets started to falter. In retrospect, we actually should have moved everything to cash in October of 2007. Very few investors had the foresight to make that market call. But that was then and this is now.

In terms of what we do know, we all understand that prices change very, very quickly both on the upside and the downside. It's not just with stocks. We've seen it with oil, we've seen it with commodities. We also know that there is a huge amount of liquidity parked on the sidelines—estimates are about $10 *trillion*—that is not earning any kind of meaningful interest. At some point, whether it's next month, next quarter or next year, this money will likely move into the markets and prices will rise, perhaps slowly, perhaps quickly.

The key question each investor must answer now relates to their individual risk tolerance and comfort level in having equity exposure in view of the uncertainties and lack of confidence in the markets. We do believe we are at or near a bottom but this could be a long, slow recovery.

What have your other clients been doing in this environment?

Of the 400+ accounts we manage, you can count on one hand the number of clients who have shifted their asset allocation around as a result of the recent tumultuous market conditions. In these cases we have generally taken a more conservative approach by increasing their fixed income exposure and reducing their equity exposure. Only five of our accounts have moved to all cash.

Any other advice on how to cope with the current market?

Although the math and science of our investment process are critical to our program, we are keenly aware of the importance of the *emotional* element of risk management for clients. Is it time to jump out the window? No, and here's why: With each passing day, we are getting closer to when the recovery starts. Anyone who's been in the business over recent decades understands that those who remained calm during rough patches had a more successful investment experience than those who succumbed to their emotions, particularly in highly volatile periods. Emotion is the enemy of reason. In the end, logic is a better way to make financial decisions than relying on emotion. In time, this really *will* get better.