

## **RISK MANAGEMENT FOR INDIVIDUAL INVESTORS**

A lot has been written about investment risk. However, much of what the average investor hears about risk is not about risk at all – it’s about volatility. The two are not the same and should never be confused. I present 3 key strategies for limiting investment risk for individual investors that are independent of a portfolio’s volatility. But first, I think it’s wise to discuss why the investment management industry conflates risk and volatility.

### **Risk vs Volatility**

By and large, the retail investment business has a fundamental belief that stocks, bonds and nearly all run-of-the-mill investments you see in brokerage accounts, retirement accounts and insurance policies will go up over time. It is such a strong belief that any suggestion to the alternative is either completely dismissed or is thought to be so perilous that no other investment or strategy could possibly insulate one from such a catastrophe. Oddly, there is no other belief or even a moderating suggestion that many of these investments can do anything but rise over time. There is little acknowledgement that they could stagnate for several decades, decline slowly over time, have an inflation-adjusted return of less than 0% for many years or bounce around a flat return for a lifetime. There are many directions and courses that a market *may* take but only one is considered the determined path that they *will* take – up.

That is enough to send up some red flags about how much the investment industry really understands about investment risk. If you have at least one skeptical bone in your body, you should now be sufficiently aware that this is a potentially huge problem. And I don’t feel that it is wise to rest our entire risk mitigation strategy on a near-religious belief that there is only one, predetermined path that the markets will take.

But I don’t want to get too carried away either. Recent history is on the side of these hopeful folks. Stocks, bonds, real estate and most of the investments based on these asset classes have, indeed,



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gone up over time and this has been the norm for many generations of investors. The chances that our generation will be the exception is low. And it would be foolish to suggest that any of us can predict that “this time is different.”

However, just because it may be a low-probability event doesn't mean that we can safely ignore it, as many people do. The probability of an event isn't nearly as important as its potential effects. In other words, if by odd chance, investments fail to rise, and that could lead to our financial ruin, then it is wise to plan accordingly.

We do this in other spheres of life where risk is present. We insure against all manner of unlikely events: fire, flood, auto accidents, sudden death, health catastrophes, just to name a few. The chances are good that most of us will never need to use any of these policies. Yet we buy them -- just in case. And none of these insurance policies would ever describe themselves as mitigating volatility. Fire insurance isn't about addressing the volatility of your home's charcoal content. Nor is health insurance about addressing the volatility in your pathogen levels. They are about catastrophic risk mitigation – low odds events but those that still have potentially devastating consequences.

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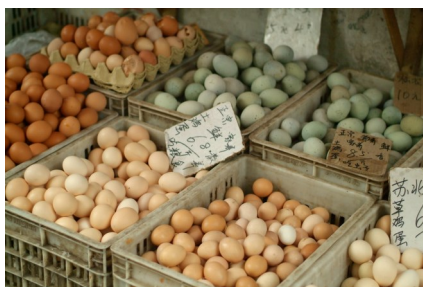
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So why does the investment industry tend to focus on volatility rather than risk? Again, most of them don't even acknowledge the possibility that there is real risk in the markets. And because they dismiss the possibility, they feel that the main risk is *you*. If the markets are, by their nature, on an upward trend, then what matters most is when investors sell. And that is a function of an investor's mood, decision-making process and life circumstances. So minimizing the volatility helps lower the odds that an investor will sell his or her investments at an inopportune time. Furthermore, if an investor liquidates his or her portfolio for a loss, then it is mainly the investor's fault for getting too emotional or failing to maintain adequate liquidity. After all, they may argue, if they just hung on for a little longer, then they'd eventually see a profit because the markets will eventually go back up. Put another way, the focus on volatility allows people to ignore that risk exists while still believing that they have addressed it.

Once again, for the past several generations, our markets have been a sound, reliable way of building and maintaining wealth over time. Volatility and risk have, indeed, been one and the same. But at the risk of repeating a phrase most people gloss over, past performance is not indicative of future results.

So if the markets can take any number of alternative paths over your lifetime, how should we invest? To this question I propose three methods to consider. Each has strengths and weaknesses. But when properly applied, they do a good job of addressing risk and volatility in an investment portfolio. This is not a comprehensive paper so there may be other strategies worth considering. Most investors should not attempt to execute these strategies on their own. Rather, they should seek advice from knowledgeable professionals who can offer insight on their particular circumstances and which, if any or even all, might best help them.

## Strategy 1: Diversification



The first strategy is the most obvious – diversification. We’ve all been told to not keep all our eggs in one basket and this bit of folk wisdom still applies today. Most investors shouldn’t just own a few stocks or a few *kinds* of stocks but an extremely broad representation of the global investment market. Some may consider U.S. stocks and bonds, for example, as the only country worth owning.

However, it’s worth reminding ourselves that a mere 200 years ago, the United States was just one of the “emerging markets” of its day. A safe bet back then would have been into various European East Asian Trading Companies (British, French, Dutch), many of which went bust later in the century. Likewise, the economies of Europe suffered heavily during the early-mid 20<sup>th</sup> century as world wars ravished the economies of both Allied and Axis countries. Only after the postwar period, after so much of Europe’s economy and manufacturing was in shambles, did the United States gain an opportunity to rise to the status of a global powerhouse. And that status has only been the norm for about 70 years – long enough to matter but also long enough to forget that it wasn’t always the case. Maintaining a global exposure is a hedge against history’s cycles. The U.S. enjoys its top-dog status but, in all likelihood, it won’t hold that title forever.

Yet there’s no reason why we should limit ourselves to the liquid markets of stocks, bonds, currencies and derivatives. Real estate (the tangible kind of real estate, not just real estate investment trusts) is also a sound investment for those whose portfolios have grown enough to partition out a slice for such a venture. Real estate investing is an art and a science unto itself and I won’t attempt to cover some of those details here. Nor am I really qualified to do that. Suffice it to say that, when part of an investor’s total portfolio, it has the potential to offer solid returns and additional diversification versus simply relying on the tried-and-true liquid mutual funds most people hold.

Over the years, I've also been asked about gold and other precious metals as a diversifier. There isn't much new data that I could present here but it is notable that metals get a lot of positive attention after they have already climbed in value and then get quietly ignored for years whenever their prices slide. Adding to the madness is a barely-regulated business of dealers who have a vested interest and a large commission spread in getting you to buy or sell. *Caveat emptor.*

Though not as complicated as real estate, metals should be given the same thought, care and strategy as any other investment. While I am loosely familiar with some of the broad strokes of how to do this, I am by no means an expert on metals investing. To be sure, it should be more thought-out than running to the nearest dealer and buying some gold coins to stash in your sock drawer. If it's worth doing, it's worth doing well. And if it's a serious venture, then it should be taken seriously. DIY investors should be extremely skeptical of anything they read on the subject. There is little regulation about what is said about precious metals, leading to a lot of misinformation and even outright lies. Nevertheless, I believe that metals can be a valuable part of an investor's overall portfolio. It's just one more basket for your eggs.

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## **Strategy 2: Barbell**



The second strategy is called the Barbell and is one of the best strategies for risk mitigation that I have ever seen. There are many variations on the barbell but a typical one is to place the vast majority of one's investment portfolio into ultra-safe investments, such as treasury bonds, cash and other short-term, interest-bearing investments. In an ideal world, these are as close to zero risk as possible. Then, a smaller slice should be allocated to ultra-high risk investments, such as options or futures on stocks or stock indices. If you picture a weight-lifter's barbell, there are weights on one side, weights on the other and nothing in the middle. Likewise with the investment barbell. There are low-risk and high-risk investments but no medium-risk. The intended result is a return that approximates that of a medium risk portfolio but without the same risk should markets fail to rise as planned.

When I was a budding stock broker, a version of this strategy was taught to us as a way to get nervous investors to put their cash to work – convince them to buy a very safe bond, such as a U.S. Treasury bond, U.S. Government agency bond or insured, highly-rated municipal bond and have the client invest their interest payments into an all-stock mutual fund. If the market crashed, we were told, the investor might lose the interest they've been earning and subsequently investing into stock funds. But they'd still have their principal (paid back at maturity). Obviously, this strategy worked better when safe bonds paid more interest than they do today. While I question how effective this strategy is at building wealth, it is, conceptually, still a barbell – minimal risk to their principal coupled with a small allocation to high risk investments.

The best use of the Barbell I've seen that is available to the average investor is from a couple different investment advisors that I have worked with over the years. One in particular holds between seventy to ninety percent of a client's assets in low-risk bond funds, treasury bonds and cash. Then the remaining proportion is given to options on a widely-traded index fund. Options are unique investments that aren't appropriate for all investors. But the results on this strategy have been impressive – not because they achieve stellar returns (they usually don't) but because they achieve average returns with only a fraction of the risk.

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A barbell like that can be incredibly difficult for the average investor to execute on their own. It is still difficult for most investment advisors who deal with retail clients. Also, because appreciated or exercised options tend to generate short-term capital gains, it isn't ideal for non-qualified accounts held by investors who are in higher tax brackets. So, again, it isn't appropriate for all investors. But it's an option and a darned good one for some people and for some accounts.

### **Strategy 3: Buy and Hedge**



The third strategy is one that I sometimes execute in my practice: Buy and Hedge. At the core, this strategy looks no different than a typical “Buy and Hold” strategy one sees with nearly all investment advisors that deal with average investors. A diverse set of global stocks and bonds is bought for the client in a proportion that matches their overall

investment timelines and volatility tolerance. Over time, we hope, the portfolio will grow and volatility should be within the client's level to handle without hitting the panic button, causing them to call the office and liquidate their holdings. Yet, a small portion of the account is also allocated to hedging instruments, such as options that profit from market declines. By definition, a hedge is something we do in case things don't work out as expected. In this strategy, we hope that the portfolio will rise and we hope to avoid sharp, sustained losses. Put another way, we hope that the hedge is a waste of money. But in case it doesn't work out that way, the potential profit from the hedge should keep the portfolio losses to a tolerable level. This strategy is rarely used by retail clients but rather common with institutional investors, such as pensions, endowments and private wealth funds.

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To be sure, Buy and Hedge has some weaknesses as well. Not the least of which is the availability of hedging instruments during market panics. The classic Buy and Hedge strategy, known as Portfolio Insurance, suffered tremendously just a few decades ago. In the late 1990s, as stocks and portfolio values fell, put option prices skyrocketed, pricing out many buyers of this “portfolio insurance” (put options typically rise in value as their underlying investments fall). For many, it was like trying to buy fire insurance after their house is already on fire – good luck. Likewise, in 2020, put options on stocks rose sharply in value early in the COVID panic but quickly became so expensive as to question whether it was worth further investment.

In general, maintaining a constant hedge is also very expensive. And if purchased too late, it can be downright pointless. There are other risks as well. But having a strategy that can use occasional hedges to insulate the portfolio from losses while investors wait for better days to return is yet one more risk reduction method that is worth consideration by the average investor.

While global diversification and “Buy and Hold” are fairly easy to achieve with lifestyle or age-based funds, like one typically sees in employer-sponsored retirement plans, the Barbell and “Buy and Hedge” strategies are best left to the professionals. Those two strategies don't do well with neglect – they require constant attention. But they can offer, net of fees, the potential to drastically cut both risk and volatility to manageable levels while maintaining the growth potential of a more typical medium-risk portfolio.

## Summary

At this point, it should be evident that none of these strategies can promise outsized returns – even in good years. But that was never the point. The objective is simply to reduce the catastrophic risk. Hypothetically, if risk can be reduced and negative returns can be softened a little in bad years, there is a strong chance that better performance may, indeed, be achieved. That certainly isn't guaranteed and isn't likely to be by a wide margin. But by mitigating our risks, we can hope to sleep better at night, watch election cycles and market turbulence without the undue stress of feeling like we're constantly exposed to financial ruin. Having a strategy to re-

duce our risks, not just moderate volatility, is a huge emotional benefit and one that can keep us from making rash decisions about our portfolios as the world turns.

Having addressed risk, in the next segment, I plan to address how we can turn volatility into an ally rather than an enemy.

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