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Portfolio risk management: mitigating volatility's impact

By JACK PAYNE
Special for Lehigh Valley Business

As we prepare to celebrate the 40th anniversary of the movie classic "Jaws," investors may be wondering if it is safe to enter the financial market waters.

After an extended period of below-average activity, market volatility could be set to escalate in the coming weeks as the Federal Reserve considers a change in monetary policy.

While there have been isolated dislocations in the financial markets, such as the drop in oil prices and the rally of the U.S. dollar relative to other currencies, the past 2½ years have been relatively calm by historical standards. Like those beachgoers on the shores of Martha's Vineyard in Steven Spielberg's hit movie, investors hope to avoid the metaphorical shark attack and manage the effect of volatility on their portfolios.

What is an investor to do if volatility picks up?

First, it is critical to understand that volatility, in and of itself, is not risk. Volatility is the movement of price in markets whereas risk is the probability of actually losing money.

The two measures become one if the volatility in price forces you to sell at a loss. As such, strategies to dampen volatility can reduce the probability of an actual loss and, therefore, can reduce risk.

In a perfect world, investments that exhibit no volatility (such as bank certificates of deposit or savings accounts) would provide adequate return to cover the negative impact of rising inflation. Unfortunately, that is not reality, so each investor must incorporate some risk into his or her long-term investment plans.

TIME HORIZON

One often overlooked key to dealing with volatility and managing portfolio risk is to match the time horizon for the invested money with the correct type of investment vehicle.

A 30-day horizon requires a different investment choice than a 30-year horizon.

If an investor needs money in 30 days, it would never be advisable to buy stock, since the stock price can go up or down by sizable amounts over the course of a month. In this case, it would be better to put (or keep) the funds in a money market account.

DIVERSIFICATION

What are some of the tools and techniques investors can use to mitigate the effects of volatility?

The first defense is always broad portfolio diversification. It is critical to avoid putting all of your investment eggs into one basket. Rather, investors should select a variety of noncorrelated investments, such as emerging market small cap stocks, large cap U.S. stocks, different individual bonds and real estate investment trusts.

Rebalancing the portfolio holdings as market trends affect allocation weights is another important tactic. Additionally, a good financial adviser can help investors wisely use market orders to set investment limits and implement basic options strategies to mitigate the effects of volatility and reduce risk.

EMOTIONAL OVERREACTION

Dealing with volatility is as much psychological as it is anything magical in terms of solutions.

The main reason for investors to manage volatility through sound investment strategies is to protect them from themselves. Emotional overreactions can lead to bad short-term investment decisions.

A good financial adviser will help to build a portfolio with the worst-case in mind, giving the investor peace of mind and freeing them from worry about the effects of market volatility on their investments.

Jack Payne, partner and chief investment officer of JoycePayne Partners of Bethlehem and Richmond, Va., is responsible for investment research and management of client investment portfolios and the development of comprehensive personalized financial strategies. He is a Chartered Financial Analyst, Certified Financial Planner and member of the Philadelphia Chapter of the CFA Institute. He can be reached at jpayne@joycepaynepartners.com.

LIMITING THE EFFECTS

- **Don't put** all of your investment eggs in one basket. Build a portfolio with broad diversification.
- **Rebalance** portfolio holdings as allocation weights change.
- **Use market orders** to establish investment limits. Trailing stop losses can be used to define an absolute downside minimum. Buy limits can be set to establish when to buy investments.
- **Incorporate** basic options strategies such as buying puts and establishing collars.