

Swimming Naked

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One of Warren Buffet's most famous quotes is "It's only when the tide goes out that you learn who has been swimming naked." Zero percent interest rates made a lot of ordinary investors look like superheroes, but now as rates have risen at their fastest pace in 40 years, many companies and investors are getting wiped out, clearly separating speculators from long term patient investors on a plan. As your portfolio managers, tasked with the allocation of your capital, our job is to generate a positive return on your money over time. At the same time though, we believe its not just about return in a vacuum, but rather, return for the amount of risk we have to take on. There's dozens of way to blow up your financial future, but in our experience, there's five key risks that can be mitigated with careful planning.

Risk #1: Under diversification – Some investors have placed all their eggs in one basket. They've concentrated significantly into one stock or sector, believing nothing can ever go wrong with their favorite company. Throughout our risk management process, we follow a rules-based approach with your portfolio that caps sector and single stock exposure at acceptable statistical driven limits. For example, we don't want more than 25% in one industry or more than 8% in one stock. Our due diligence and rebalance process forces us to systematically take profits from sectors and stocks that have done well and reinvest those profits into sectors and stocks that are currently underperforming. By doing this over time, we don't eliminate risk, but we keep you in the middle of the road, never owning enough of something to get clobbered.

Risk #2: Market Timing – Decades of research has shown market timing is a failed strategy. While you might be right getting out, you have to be right twice, knowing when to get back in and not miss the market's recovery. Instead of trying to time the market, we want to engage in an asset allocation strategy that aligns with the current economic environment and your personal financial plan. For example, during a rising interest rate environment, we want to pivot away from long term assets into shorter term assets. If you miss even a handful of the best stock market days, you can seriously crush your portfolio's return.

Risk #3: Federal Reserve – While we vote for our President, Congress, and local representatives, no one votes for the Federal Reserve. The Fed has become a quasi-fourth branch of the government that happens to hold more power than the other three combined. Martin Zweig, a famous finance professor and investor once said, "Don't fight the Fed." Despite strong company fundamentals, the Fed can push even the best balance sheets into bankruptcy if they mismanage inflation and raise interest rates too quickly. At the same time, even the worst run companies can look like blue-chip stocks when rates are low. If you aren't managing interest rate properly, you can end up like SVB, collapsing under the weight of crushed bond prices.

Risk #4: Inflation Risk – Like Milton Friedman once said, "Inflation is always and everywhere a monetary phenomenon," which simply means when the government prints money, the value of that money is worth less. Over the past 200 years of U.S. economic history, both sides of the political aisle have printed money to achieve their policy goals. If you live long enough, you'll watch your purchasing power plummet. Not owning enough equities, which have the power to beat this inflation over time, can cause you to run out of money during your lifetime. We've encouraged our clients to mostly own equities even as they age, to continue beating the rising cost of living.

Risk #5: Behavioral Risk – As equity investors, we know bad things will happen, shaking even the best investors to their core. How we react to these "Black Swan" events is the difference between long term financial success and failure. There will be plenty of doom and gloom over our lifetimes so the best thing to do is tune out and stick to the long-term plan we've created for you and your family.

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