



Diversification Is Not Enough

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Ever have a “friend” whose house was broken into and then realized he or she did not have replacement insurance? Or had a tree fall on his or her car resulting in damage that ever so slightly exceeded the ever-so-large deductible? The thought of being uninsured or underinsured for the one event that in retrospect was likely to occur is not a good feeling. Americans, for the most part, do insure their cars, homes and even their lives, but the biggest asset most Americans leave uninsured is their investment portfolios.

TYPES OF RISK

A stock investor’s portfolio has three types of risk:

1. A specific company having a problem.
2. A sector having a problem.
3. The overall market having a problem.

For years, investors, brokers and financial planners have looked to diversification to lessen these risks. Owners of bigger accounts have sought to possess a large number of stock positions. Some even say no single position should account for more than X percent of an account—usually around 3 percent to 5 percent.

Other investors have sought diversification through the purchase of a single vehicle (the unit investment trust of years ago), then the closed-end funds, the open-end funds (the mutual funds we still seem to relish) and, most recently, exchange-traded funds.

These solutions are neither inherently good nor evil, but the problem is how they are portrayed to the public.

If you were to ask people on the street who manages the risk of a fund in their 401(k), just about every person would respond with “the fund manager.” However, the fund manager’s response would be “I am paid to buy stocks.” He or she assumes that the risk management is administered by you—the person who decides how much money to place in that fund. Each party believes that the other is doing the risk management, and that means no one is taking care of it.

Portfolio managers are graded on a curve and are compensated on the basis of how they did relative to their specific fund’s benchmark index. If you were lucky enough to be in a large-cap fund last year that *only* lost 35 percent, not only were you “fortunate” (since the S&P 500 lost 38 percent), but the fund expenses probably reflected a good bonus for performance. In fact, Morningstar’s Manager of the Year lost 20 percent, and if you were lucky enough to be in that fund, you should feel really good that the benchmark index was thoroughly throttled.

MORE THAN DIVERSIFICATION

Diversification is a desirable goal; it does an excellent job of reducing account risk due to specific company problems or specific sector problems. In essence, diversification significantly reduces two of the three types of account risk.

However, the more diversified your account is, the more market risk your account has, and the more your return is correlated with one or more of the benchmarks in Figure 1.

(Continued)

FIGURE 1: Major Indexes 2008 Performance (Not Including Dividends)

Index	12/31/2007 Price	12/31/2008 Price	YTD Point Change	YTD Percent Change
S&P/Citigroup 500 Value Index	760.95	447.11	-313.84	-41.24%
NASDAQ Composite	2,652.28	1,577.03	-1,075.25	-40.54%
Russell 1000	799.82	487.77	-312.05	-39.02%
Dow Jones U.S. Total Market Index	357.48	219.66	-137.82	-38.55%
S&P 500 Index	1,468.35	903.25	-565.10	-38.49%
S&P MidCap 400 Index	858.20	538.28	-319.92	-37.28%
S&P/Citigroup 500 Growth Index	702.66	450.55	-252.11	-35.88%
Russell 2000	760.03	499.45	-260.58	-34.29%
Dow Jones Industrial Average	13,264.82	8,776.39	-4,488.43	-33.84%
S&P SmallCap 600 Index	395.14	268.73	-126.41	-31.99%

Source: AllFinancialMatters.com

Uninsured market risk in an investor's account is not something typically discussed by brokers or financial planners because they avoid using the tools that could significantly lower market risk, hence it is a taboo subject.

But most of the investment problems people have had in the past were due specifically to market risk. For instance, the 38 percent decline in the S&P 500 last year, the NASDAQ's fall of 78 percent from top to bottom in 2001 to 2002 or the first Resolution Trust Corporation in the early '90s—all market risk. And let us not forget the crash of 1987 or the implosion of the Nifty Fifty for the old-timers.

These events all have one thing in common: Before each event, all the talking heads declared it was "a stock picker's market" and excused that statement after the fact by saying, "There was no place to hide."

A true measure of market risk might be a comparison of what return you would have received, if in Q1 2008, you or your portfolio manager saw a downturn coming and moved into defensive positions at the end of that quarter and held them throughout 2008. Typical defensive positions include such sectors as defense, consumer staples, health care and utilities.

So how did some of those areas fare? Well, in 2008 PowerShares Aerospace & Defense Portfolio declined 39 percent, along with many other defense stocks. What about household goods such as Consumer Staples Select SPDR? It was also down by 23 percent. And Kimberly-Clark, parents buy diapers no matter what, right? Apparently not as much; the company was down 24 percent. What about Healthcare Select SPDR? Of course, health care is not cyclical. Actually, it also took a beating with a decline of 22 percent.

Since defensive stocks were all significantly down (true, there was no place to hide), that indicates a high level of market risk.

The only way to avoid this risk would have been to have no market exposure at all—or have price insurance. If you ask investors, especially individuals in mutual funds, why they are still in the market, the general response would be "After all I lost, I am afraid to miss the up move." In that response, there is no indication of any research or specific market opinion that communicates anything other than investors are frozen in place.

Thankfully, exchange-traded funds on major indexes and some minor indexes, as well as S&P 500 sector indexes, all have very liquid options traded on them, which allows individual investors to select a risk profile other than "all in" or "all out."

LEAP FORWARD

Another way for individual investors to manage their risk was introduced by the CBOE in the early '90s with products called LEAPS (Long-term Equity Anticipation Securities). These are options that extend the expiration date up to three years in the future. More than anything else, LEAPS changed the option user and allowed the investor to use the option product.

Prior to LEAPS, most of the options traders tended to be attracted to the product primarily by the leverage aspect and were mostly young with high-risk profiles. LEAPS changed that, and typical clients now use the option product as a risk-reduction tool. For example, PTI Securities' current...

investors' average age is double that of clients from 15 years ago, and their average account size is significantly higher, while their risk profiles are much lower. In essence, the age of using the option product as an investment risk-management tool is upon us.

Because LEAPS options have a long time until expiration, there is less time decay (or cost to hold the position if you were to own the option). Because the cost of insuring a stock position per day is significantly decreased using LEAPS puts, it has now become cost effective for investors to have price insurance in place.

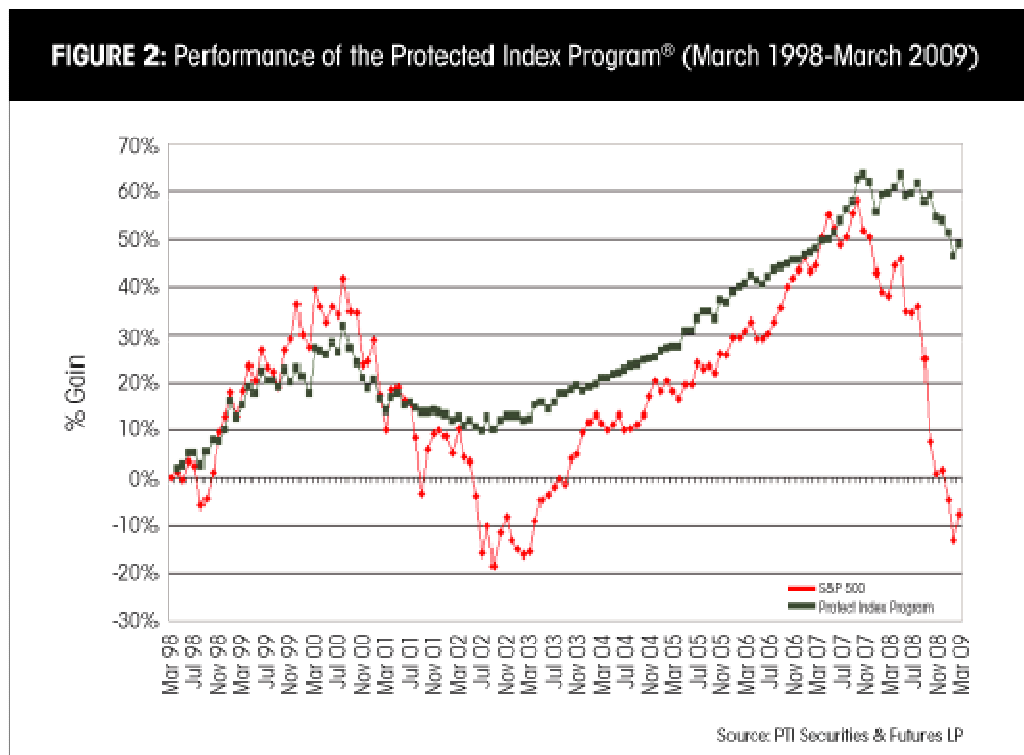
The main problem with these management tools is that the majority of professional money managers still do not use them or offer a risk profile that contains them. It is hard to imagine why there has not been a regulatory or market-driven push to provide this risk profile to low-risk investment accounts as exchange-traded options have been around for 36 years and are certainly not new or untested tools.

The fund managers are right about one thing, though: It is the responsibility of account holders to select how much money they decide to place in the market and how much they would like to have in different risk profiles. So individuals who want protection need to search for money managers who provide this type of risk profile.

INSURANCE PLAN

To manage your risk and price protection, look for a plan such as the Protected Index Program®, which PTI Securities has designed and implemented since the late '90s. This entails purchasing a diversified ETF, buying put protection on that ETF with LEAPS and selling a covered call. By selling covered calls, additional cash can be generated, helping to offset the cost of put protection. Individual investors can select the benchmark index in which they desire to invest, the level of price protection (puts) they require for their situation and how much upside they are willing to forgo (what level of covered calls they are willing to sell).

Once again, because the time decay or cost of owning an option has been more dramatic in the past several months, buying long-dated put protection and selling short-dated call options (where time decay is greater) is advantageous. This strategy has resulted in a more than 10-year track record that shows a much higher return than the market, along with considerably less market volatility (see Figure 2)—a protected account not participating in some of the dramatic peaks of the market but also not participating in the dramatic valleys.



The net result is significant outperformance primarily due to dramatically lower drawdowns in market pullbacks.

This is a risk profile that is much more in line with the expectations of longer-term—especially retirement-focused—investors. It has been my experience that most of these type of investors have little if any desire for more than a 10 percent to 12 percent drawdown in their accounts, as their timeframe just cannot support much greater. So, for these investors and many others, failing to use the available risk-management tools would be a total disservice.

Investors need to ask the important question, “How much of my nest egg needs to be insured?” Gone are the days when clients’ only alternative was unlimited and uninsured downside risk if they wanted to invest in the market. For all who desire less volatility in their investments, the understood constant should be price insurance in place for every share of stock owned in the safe investment allocation.

Are these choices more difficult than mutual fund investing? Yes, but isn’t the security of price protection and an absolute dollar amount of identifiable risk worth the extra time and effort?

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