

The Northwood Perspective

Tips for Managing Investment Risk



Northwood Family Office is Canada's leading independent, privately-owned boutique family office which provides comprehensive Net Worth Management™ for wealthy Canadian and global families.



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Managing Investment Risk

Risk management plays a central role in so many areas of our lives. Sensible precautions are ingrained in our day-to-day activities. We stretch before exercising to avoid injury. We wear helmets and padding to participate in contact and speed sports. We set passwords to protect our personal data. And (most of us!) stay seated and wear our seatbelts during takeoff and turbulence.

However, when families come to see us for advice on investing their wealth, we are often surprised by the amount of unnecessary risk they have taken on. For many families, the investment portfolio plays an important role in helping them meet their financial goals. Yet, a poorly structured portfolio strategy could compromise the value of their investments and their financial well-being as a result. In our experience, there are several reasons why investors take on more risk than they are required to, or can afford to. To name a few:

- Investing too aggressively, to make up for previous losses
- Getting caught up in investor optimism at the tail end of a bull market
- Chasing return from the hottest asset class
- Reacting to events that cause short-term volatility, but have no material impact in the long-run

Here are three steps that can be taken to avoid these types of pitfalls.

Identify and Quantify Your Goals

We recommend that all investors spend the time identifying and then quantifying their financial goals. It is worth the effort to specifically calculate how much you expect to spend on your living expenses over your lifetime, and how much you plan to give away during your life and at death. The answers to these questions will go a long way in helping you set the appropriate investment strategy. Quantifying these goals will allow you to establish the investment return you will need to achieve and reasonably assess the associated risk. Often, if a family has a large capital base, they will find that they do not need to take on a significant level of risk to meet their goals.

Focus on Capital Preservation

Many wealthy families, particularly entrepreneurs, took risk to build up their capital base. At later stages of their lives (when it would be hard to start over again), their primary objective is to protect this capital. In our years of practice, we have also learned that by employing the risk management strategy of investing first to protect capital, the family's portfolio actually ends up better off over time. The portfolios we manage for clients have historically offered significantly better downside protection when markets fall, while still capturing most of the market upside. This is a very conscious strategy and involves selecting managers with a focus on capital protection. By outperforming when markets drop, these managers need to cover less ground to recoup losses.

Figure 1: Asymmetry of Positive and Negative Returns

Negative return	Necessary offsetting positive return
-10%	11%
-20%	25%
-30%	43%
-40%	67%
-50%	100%

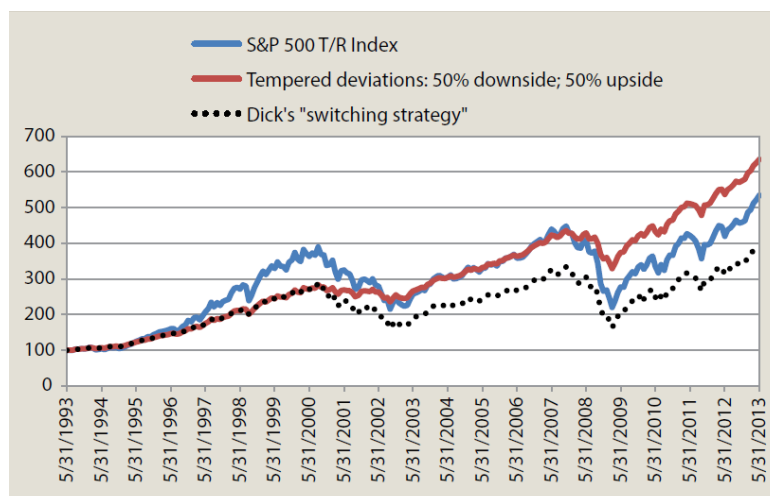
Source: 'Risk Management as Alpha Generator', Jerry A. Miccolis and Marina Goodman, *Journal of Financial Planning*

By contrast, investment strategies that allow larger performance swings (including greater declines) have to work much harder to offset their down market losses. In fact, as losses become more severe, the required offsetting return escalates. The table in Figure 1 above highlights the asymmetry of positive and negative returns. It was originally featured in an excellent article,

For instance, if a portfolio drops 10%, it must subsequently rise 11% to get back to even. But if it drops 40%, it has to rise by 67% to recover the losses. This asymmetry works in favour of conservative, lower volatility managers (i.e. those that perform better when markets drop but can still 'keep up' when markets go up) to outperform over the long-term.

The chart in Figure 2 below demonstrates the long-term benefit of a risk management strategy centered on downside protection. The solid blue line (middle) represents a portfolio simply invested in the S&P 500 Total Return Index, which reflects the 'market' return. The solid red line (top) represents a more conservative investment strategy that captures just 50% of the market downside, but only 50% of the upside. The dotted line shows an investor that initially took the more conservative investment approach, but then became frustrated as the market advanced through the tech craze, and then switched to a 'market' investment strategy just prior to the tech bubble bursting. You can see that committing (and sticking) to the more conservative strategy has yielded better results over time and through periods of significant market volatility.

Figure 2: The Long-Term Benefits of Conservative Investing



Source: 'Risk Management as Alpha Generator', Jerry A. Miccolis and Marina Goodman, *Journal of Financial Planning*

Invest for the Long Run

There is another benefit of a lower volatility investing strategy. We have also found that by experiencing less severe losses during down periods, investors do not feel the same emotional pressure to adjust their portfolios during periods of volatility. Instead, they can concentrate on the long-term, which is normally the period that matches up best with their actual goals. The recent 'Brexit' referendum is a good example. Britain's vote to 'leave' the European Union stirred up significant volatility in the global markets as investors processed the surprise. North American markets initially dropped significantly, only to completely rally back in a matter of days. There were surely investors that sold into the panic, crystalizing losses and missing the upside as markets quickly recovered. Because of our conservative low volatility investing style and a rigorous focus on the long term goals of our investors, during the turmoil we (nor our clients) never felt compelled to make a kneejerk sell decision based on the noise of the day.

Simple, but Not Easy

As Warren Buffet has often said "Investing is simple, but it is not easy." It requires a dedicated effort to avoid risk while still participating in growth assets. Our experience shows us that above-average returns will be a natural outcome of a proper risk management process.

Northwood Family Office

Northwood Family Office is Canada's leading independent, privately-owned boutique family office which provides comprehensive Net Worth Management™ for wealthy Canadian and global families. Northwood also serves as a Chief Investment Officer (CIO) for client families, helping them assess their objectives, design an appropriate investment policy, select and manage investment managers and provide comprehensive reporting.

Northwood client families typically have \$10 million or more in family net worth.



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