

WESCAP MANAGEMENT GROUP

1314 W. Glenoaks Blvd., Suite 204
Glendale, CA. 91201
(818) 552-2130

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Items of Interest to WESCAP Clients and Other Interested Readers

A Four-Letter Word Defines this Market

Make sure no one with tender sensibilities sees this, because we are going to discuss a word that many have been recently exposed to. All right? Ready? Here it is: RISK!

If you took that without palpitations try these on: Interest-rate risk, market risk, default risk, volatility risk, reinvestment risk, loss, theft and fraud risk, currency risk, business risk, forecasting risk, bad data risk, liquidity risk, purchasing power risk, tax-law risk, time-horizon risk, policy change risk, ...

As you might have guessed, there are many types of risk. Risk is a multi-dimensional concept. As a result, you must discard the idea of a riskless investment or portfolio strategy. THERE IS NO SUCH THING AS A RISKLESS INVESTMENT.

For example, take a 3-month government US T-bill, which is considered by many to be "riskless". T-bills are riskless when return of principal and interest income is considered over only a 3-month period.

However, T-bills are not riskless under other criteria. In fact, they can become quite risky under different risk criteria. Consider reinvestment risk. When you invest, you don't know what interest rates will be 3 months later. If rates are lower in 3 months, then you must accept a lower

level of income going forward. In 1993 short-term interest rates fell to about 3%. What happened to all those retirees who had invested earlier at 5% to 7% and became accustomed to living off that level of income? Risky? You bet!

Using the same T-bill, consider purchasing power risk (also called inflation risk). An investment that does not keep up with inflation suffers "real" erosion of value from this risk. According to 70+ years of data by Ibbotson and Assoc., T-bills have managed to beat inflation (CPI) by about ½% per year. So unless you could get by with only a ½% "real" rate of return, a T-bill is very risky on a purchasing power basis. Since most of us pay federal income taxes, T-bills have had a negative real after-tax rate of return. Money market funds and short-term CDs offer similar risk profiles.

If, like many, you need a minimum after-inflation rate of return to meet your long-term retirement, education or other goals, then T-bills and equivalents become high-risk investments because they are unlikely to achieve your objectives (For details, we can send you an article titled "When Treasury Bills are riskier than common stocks").

Since there is no way to avoid all risks, the goal should be to manage risk. Taking the

risks that you can afford to take while avoiding those you can ill-afford becomes the key to sound portfolio management.

In the example of the retiree who needs consistent income, T-bills could be replaced with longer-term bonds. The principal of the bond may fluctuate as interest rates change (interest rate risk), but the level of income stays the same until bond maturity.

Purchasing power (inflation) risk, which bonds are very sensitive to, can be reduced by: 1.) Adding stocks or other “growth” assets, or 2.) Reinvesting part of the bond income to offset future expected inflation, or 3.) Investing in inflation-indexed bonds or common stocks in which the dividend is expected to grow faster than inflation.

Portfolio design starts with asking yourself the right questions such as: How much do I need to withdraw from my portfolio now? Later? How long will I need to rely on my assets? What sources of cash do I have for the unexpected? Do I have adequate insurance and the ability to borrow if needed? What rate of return must I earn to be financially secure? How much portfolio decline can I tolerate, and for how long, before it jeopardizes my financial security or peace of mind?

Many risks can be reduced easily. Business risk can be reduced through simple diversification—add more investments. Other risks can only be reduced through risk trade-offs. The key is to consider risk at

the portfolio level. Typically a wide variety of different investments with different risk attributes makes the most portfolio sense.

Over-reliance on a narrowly focused strategy can lead to disaster no matter how well it has worked in the past. Markets are dynamic, shifting and certainly are difficult to predict in the short-run. In other words, your portfolio had better be attuned to uncertainty rather than to consistency. Such a broadly-diversified strategy can never keep up with the most recent “hot” investment. In fact the hallmark of a truly diversified strategy is that parts of it should be expected to do relatively poorly at any given time. If they are all doing the about the same, you are not really diversified.

A number of steps need to be taken in order to design a risk appropriate portfolio. First, **define** your needs. **Identify** the threats to meeting your needs. **Educate** yourself or seek assistance and use this knowledge to reduce these threats with acceptable trade-offs and costs. **Accept** other risks that cannot be reduced or eliminated without materially increasing the risks that you cannot afford to take. Stay **disciplined** despite temporary setbacks, which are inevitable and thus should be expected.

We have recently updated our investment risk/return questionnaire. It is useful in asking the right questions and identifying areas of inconsistency or conflicts. Let us know if you would like to receive this.

If you have questions about the above, please contact Mark Gleason, Rick Weinlein or Joel Edstrom at (818) 552-2130, fax: (818) 552-2133, E-mail: Wescap@aol.com. WESCAP Management Group has obtained information from sources believed to be reliable, but no guarantee can be made as to its accuracy. WESCAP Management Group provides high quality, personalized, objective financial and investment advice to individuals.