Market Outlook
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Rethinking Risk

The recent nerve-wracking declines on Wall Street have investment pundits rushing to their trusty sources to seek the answer to the question "why?" With the economy in decent shape it seems unlikely that a recession is near, though one can always find analysts who are predicting that one is "looming on the horizon." The war in Iraq no longer surprises, with its daily report of casualties and intractable descent into civil war. Even oil prices that have vaulted back over $70 a barrel don't seem to faze consumers or investors anymore. No, the answer to the question "why?" seems to be that investors are rethinking their taste for risk.

Rethinking risk is a time honored phenomenon in the investment world. After the depression of the 1930s and the concurrent wipe-out in stocks, investors were so averse to stock risks that, for about 20 years, they only invested in companies whose dividend yields were much higher than bond yields to compensate them for the higher perceived risk. In another instance, bond investors that systematically underestimated inflation in the late 1960s and 1970s had woefully poor returns. Consequently, in the 1980s and 1990s, they kept interest rates higher than they would have been based solely on (falling) price inflation. A new attitude toward risk prevailed in each case, affecting securities values for a long time.

"To you, the stockholders—better luck next time!"

Risk means many things to people. Moreover, the worthwhile payoff for taking a risk varies wildly. For the casino gambler, a risk may be worth taking for the thrill of the occasional win, and the remote prospect of a "big payday." Certainly the casino operators have this figured out. They tilt the odds in the house's favor just enough to allow them to build palatial gambling Meccas, yet keep the crowds coming in for more.

In the wonderful world of finance, risk is only worth taking if you are likely to get paid for it. For decades, MBA students had Markowitz's guiding principle of Modern Portfolio Theory drilled into their heads: To get higher returns, you must take on higher risk. Evidently this has become such an article of faith that bright financiers keep seeking higher and higher risks well beyond the point where common sense tells you that higher returns are virtually impossible to achieve. In other words, Wall Street is good at taking a good idea and beating the heck out of it until it blows up.

Which brings us to July 2007. Three areas have enjoyed Wall Street's favor over the past few years: private equity, sub-prime lending, and hedge funds. All three are seeing their risks reevaluated in light of the returns they may achieve. This is, in large part, what is causing the declines on Wall Street.

Private equity (a.k.a. leveraged buy-out) is a reprise of the LBO boom of the late 1980s, pioneered by Michael Milken and Drexel Burnham Lambert. Then, as now, the merry go round proceeded happily until someone said "This LBO deal is ridiculous, and I'm not going to finance it at these measly junk bond yields." Part of the hope driving the stock market of late was that each Monday a new buyout or two would be announced, hopefully a company in one's portfolio. Chrysler's plan to go private is in danger due to the inability to get anyone to finance the deal, and it may just be the tip of a rapidly melting iceberg.

Sub-prime mortgage lending seemed like a cash cow for quite some time, and lenders using sophisticated models felt quite confident that they easily control the risks of these shaky loans. What the models didn't account for was the result if everyone engaged in sub-prime lending, and then interest rates rose. Both have happened, and the chickens (more like turkeys) are coming home to roost as more borrowers are beginning to default. More significant, but with less shock value, is the world of higher-quality adjustable rate mortgages. With the recent rise in interest rates, families have seen their mortgage payments double or even triple from absurdly unrealistic initial payments. The fear on the markets is that consumers will cut back, denting demand for goods and services, and that the housing market will be flooded with inventory, prolonging the weakness in an already ailing industry.

Hedge funds are players in the above areas, and many more. They are, in essence, unregulated investment pools that can take big risks in seeking out big returns. So common have these funds become that NBC Nightly News did a feature on them about a month ago, underscoring their "mainstream" nature. Ominously, the report implied that "everyone was making big money in hedge funds." Many pension plans and government retirement plans have dipped their toes into these

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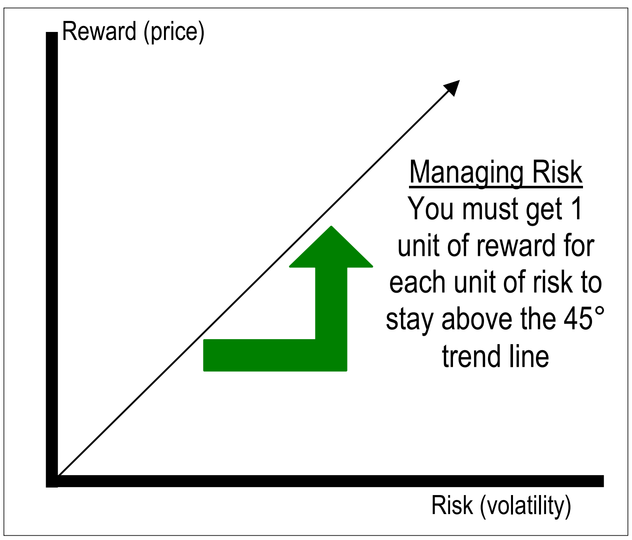
risky waters. Unfortunately, the NBC reporter did not interview the investors in two Bear Stearns funds that invested in sub-prime loans, which are now almost worthless. We expect to see some major casualties in this area as risk and reward are re-thought.

Portfolio Risk and Triage

The re-evaluation of risk does not have merely abstract effects on some high-flying hedge fund in New York. The effects on client portfolios are very real, and very worrisome. Our goal is to quantify the risk in client portfolios using two key tools.

The geometric nature of the point and figure (p&f) charting discipline we use has traditionally used a 45° trendline to eliminate short-term price volatility, and judge the major trend of a stock. This simple feature also quantifies the risk in a stock.

Consider this: The volatility, or risk, of a stock is measured as alternations of X and O columns on a p&f chart. This moves the chart pattern rightward along the x-axis. Thus, the x-axis is a proxy for risk; the more volatility, the more columns on the chart.



The y-axis measures reward in that it is the price scale. The higher the price goes, the higher the reward for holding the stock. Of course, reward can be negative also, which is everyone's current worry.

But here's the big idea. For a stock to stay above the 45° trendline it must provide one unit of return for each unit of risk. Stocks maintaining this relationship are paying you for taking the risk; those that can't hold the 45° line are providing negative rewards for the same risk! In this way, the chart has an uncanny way of sorting out the stocks to hold on to, and the ones to jettison.

The second tool is relative strength, or the performance of a stock relative to the market (i.e. S&P 500). It measures the most fundamental trend of the stock: the trend with the effects of the market stripped out. This is also plotted as a p&f chart, with a rising (slanting to the north-east) chart indicating a stock outperforming the market, and a falling (slants to the south-east) chart indicating relative weakness. This applies in up and down markets, and therefore serves as a valuable way of sorting out the winners and losers.

The word "triage" comes from the French root meaning "to sort out, or cull." In a battlefield or emergency room situation, doctors use triage to sort out who shall get immediate treatment, and who can wait. In a similar way, the tools described above help us to sort out the stocks/funds to sell from those worth holding.

Those that are breaking their 45° trendline, failing in relative strength (or worse yet, breaking the 45°line on their relative strength chart) are the first stocks to be sold. Others, not so "gravely injured," can wait—some won't make it through the correction, but some will. This allows us to winnow the portfolio in a systematic fashion without engaging in reckless selling. The idea is to sell the weakest stocks early, as they often cause the most damage in falling markets. At the lows, wherever they occur, clients will be left with a fairly strong group of stocks, though the list may have been thinned out considerably by that time.

Often unnoticed by investors amidst the anxiety and confusion of a bear market is that these tools help us identify areas where the risk reward equation is favorable, where the re-thinking of risk is in a positive, not negative, direction.

In other words, it opens one's mind to what is not declining in this market, where the relative strength is improving and the 45° trendline is holding strong. One group that seems to be exhibiting such characteristics is large-cap technology. The decline we are experiencing now is a great test for these stocks. If they hold up on a trend and relative strength basis, they may be the leaders of the next bull market. Without these tools at our disposal, we would never be able to approach the investment world from this opportunistic view.

Wall Street is a bizarre marketplace, in that demand for the good (i.e. stocks) goes up as the price rises. As prices fall, investors want less, as they are now once burned and twice shy. As risk is rewarded, investors take on more of it, but as risk is penalized, investors turn extremely risk averse. This is the Rethinking of Risk, a sudden, volatile, and painful change of mindset.

Frequently overlooked in the frenzied atmosphere of bear markets is that when risk aversion is high, your investment risk is low. It will take some time before risk aversion is so thick you can almost taste it, but we will get there. Praxis clients can be assured that rather than suddenly Rethinking Risk, we are always thinking how we will manage the risk in your portfolio.

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