5 Steps to Reducing Investment Risk

How much risk is lurking in your investment portfolio? If you're sitting on large gains, perhaps you're comfortable losing some ground when the market turns volatile and starts to head south. But can your finances – and your emotional wellbeing – handle the level of volatility your portfolio actually contains?

Below are five steps you can take to calibrate your risk so it is manageable and not derail your long-term investment goals:

#1. Put some numbers on your current exposure. One quick way to do this is to look at the average annualized volatility of various types of investments. For all major asset classes, the chart at right shows average annualized return (1st column) and volatility (2nd column), ranked from highest to lowest.

15-Year Annualized Return and Volatility
(Jan. 2005 – Dec. 31, 2019)

	15-Year Annualized Return	15-Year Annualized Volatility#
Best Performance	US Large Stocks 9.17%	Emerging Markets Stocks 21.43%
	US Small Stocks 8.19%	Global REITs 18.70%
	Emerging Markets Stocks 7.82%	US Small Stocks 18.64%
	Global REITs 7.81%	MSCI EAFE 16.17%
	Diversified Portfolio* 6.56%	Commodities 16.48%
	MSCI EAFE 5.29%	US Large Stocks 14.06%
	Illiquid Hedge Funds 4.72%	Diversified Portfolio* 10.85
	US Bonds 4.33%	10yr Treasury Bonds 6.93%
	10yr Treasury Bonds 4.21%	Illiquid Hedge Funds 5.79%
	US Municipal Bonds 3.52%	Liquid Hedge Funds 5.40%
	Liquid Hedge Funds 0.91%	US Bonds 3.18%
Worst Performance	Commodities -3.13%	US Municipal Bonds 2.72%

Source of Data: Morningstar.
Please see disclosures located at the end of this paper.

In technical terms, annualized volatility is measured by standard deviation, which estimates the likely range of an investment's price moves.

As you can see on the chart, average annualized volatility can vary widely – from less than 3% on low-risk municipal bonds to more than 21% for emerging market stocks. The higher the volatility, the higher the variation in likely returns and therefore the higher the risk.

As the chart at right shows, large US stocks have been the #1 asset class over the past 15 years, with an average return of 9.2% annualized. That is quite good. To get that return, you would have had to accept volatility of around 14% in both directions (up and down). This is certainly not the highest volatility (emerging market stocks got that honor), but it is still considerable. Typically, asset classes with the highest volatility tend to offer the highest returns over time, and vice versa.

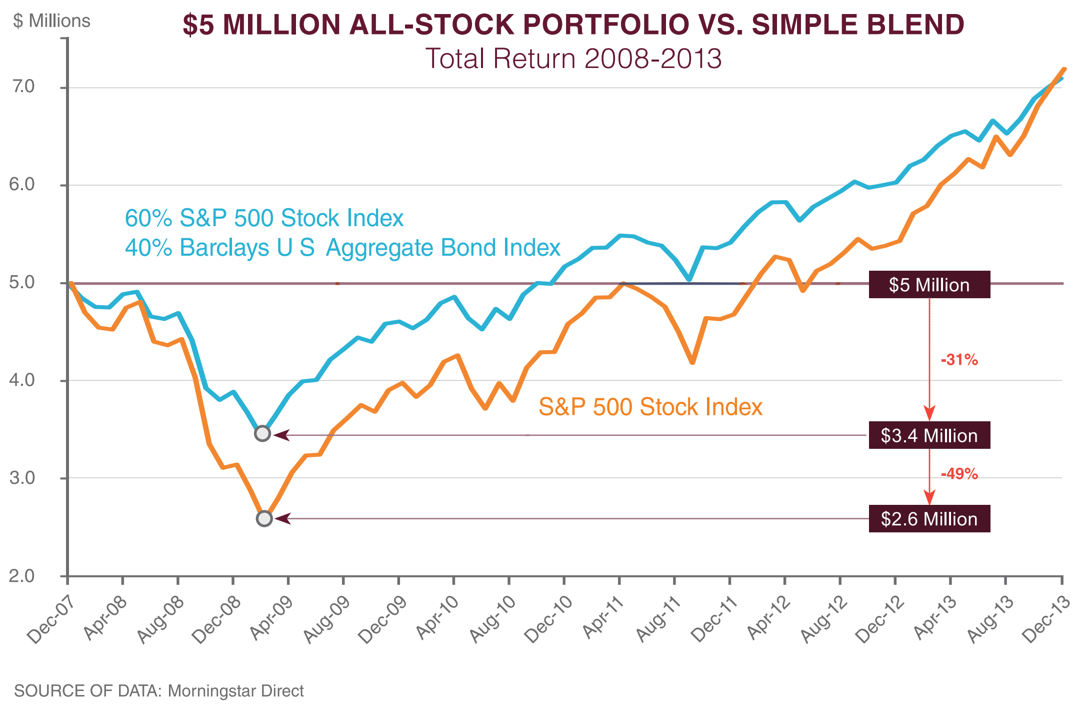
#2. Set a volatility target that works for you and your goals. The buying power of your portfolio can shrink over time if you take on too little risk: you will not keep up with inflation, taxes and investment fees. On the other hand, your assets can also shrink if you take on too much risk and are forced to sell at a loss. So, you want to find a balance that works for you.

What size of loss can you live with? And for how long? A 20% drop in prices means a $1million unrealized loss on a $5 million portfolio. While that loss may turn into a gain again over time,

can you sit comfortably until if and when it does? It may seem counterintuitive, but lowering portfolio risk to moderate levels usually leads to higher long-term returns for two reasons:

- First, with lower volatility, the cash flow from your portfolio is likely to be more reliable.
- Second, you're less likely to sell during a market plunge – either out of fear or for cash flow reasons — derailing perhaps years of wealth buildup.

Take a look at the chart below, which shows returns on two different portfolios during the Great Recession: (1) a higher-volatility portfolio invested in the S&P 500 Stock Index; and (2) a less-volatile portfolio comprised of 60% stocks, 40% bonds. Ask yourself: Could you sit still if your $5 million all-stock portfolio lost nearly 50% of its value?



Also keep this in mind: The higher the volatility, the bigger the price drops are likely to be. And big declines are harder to recover from, since you then have less money invested. A 33% drop, for example, takes a 49% rise to get you back to where you were. A big decline at the end of an intended investment horizon can dramatically lower your realized return. Note on the chart above that the lower-volatility portfolio (60% stocks, 40% bonds) had a smaller relative loss and faster recovery period, making it more likely you'd stay invested long enough to benefit from the recovery.

#3. Diversify your portfolio to target a level of risk that is realistic for you. There is little reason for high-net-worth portfolios to be concentrated in any one type of asset, since this greatly reduces the potential for managing risk. Concentration can be shares in your company's stock, an all real estate portfolio, or even 100% cash.

How do you diversify? Mix and match among the different asset classes. Take a look at the chart on page 1 again. As you can see, each asset class has unique risk and return characteristics. By analyzing average return, average volatility, and correlation (the degree to which investment prices tend to move together) it is possible to develop a strategically diversified portfolio that targets a level of risk you are comfortable with – say around 10% — and also captures a return that will allow you to accomplish your goals.

At Laird Norton Wealth Management, risk management is a cornerstone of our investment approach, and is supported by sophisticated asset-allocation modeling and testing, allowing us to draw on the strengths of each asset class while minimizing its shortcomings.

#4. Rebalance (at least annually) to adjust to your target allocation. With US stocks having performed very well during the past 10 years, many portfolios have become stock heavy. By selling and using the proceeds to invest in asset classes that haven't performed as well (in line with your target allocation), you are more likely to sell high and buy low, not necessarily timing the markets but managing your risk to keep it within expectations.

#5. Consider adding some alternative assets and commodities. Globalization, computerized trading and thousands of new financial products have created new challenges, including:

- Markets moving more in tandem (higher correlation), making it harder to achieve the level of diversification required to lower risk;
- Occasional bouts of heightened short-term volatility; and
- Higher "event risk," or the likelihood that one event will trigger massive selling.

To offset these relatively new risks, portfolios could benefit by adding carefully selected alternative assets, such as hedge funds and private equity funds. The benefits can be twofold:

(1) The returns on alternative assets have varying correlations with traditional assets like stocks and bonds, providing enhanced diversification; and

(2) Alternative asset managers have recourse to more strategies (short-selling, arbitrage), which can be used to manage risk during market disruptions and downturns.

Risk Management at Laird Norton Wealth Management

Our focus at Laird Norton Wealth Management on fully informed, intelligent risk-taking. We strive to understand and exploit specific investment opportunities as they arise and to manage your overall portfolio risk by mixing exposures to the various asset classes, and other methods. To do so, we apply robust risk analysis, including quantifying market risk, understanding how asset move together (or not), and "what if" scenario analysis, both before and after we invest.

Look at the questions in the box below. For each client portfolio, we answer questions like these not just once but all along the way. This makes it more likely you will benefit from (1) a consistent strategy that keeps you invested through market downturns; and (2) more stable cash flow.

LNWM Portfolio Risk Analysis

- **Probability of a loss:** What's the probability your portfolio will lose value in any one year? What's the probability of a 10%, 20% or 30% price decline?
- **Stress-testing and worst-case scenarios:** What is the most you're likely to lose in any one year?
- **Risk forecasting:** What level of confidence can you have in your portfolio's performance (risk and return) assumptions?
- **Risk profiling:** What level of price volatility can you and your finances realistically sustain?
- **Risk/return optimization:** What portfolio holdings are most likely to get you the highest "real" return (after taxes and inflation) for that level of volatility?
- **Hedging strategies:** In worst-case scenarios, which alternative investments are likely to be the most effective hedges?

DISCLAIMER

Past performance is no guarantee of future results. Data as of 9/30/2018. Returns are for period and index indicated "Diversified Allocation" returns assume quarterly rebalancing.

*Diversified allocation is: 10% US Municipal Bonds; 10% US Core Bonds; 25% US Large Cap Equities; 5% US Small-Cap Equities; 22% Int'l Developed Equities; 9% Emerging Markets Equities; 4% Global Infrastructure; 13% Illiquid Hedge Funds; 2% Commodities.

#Annualized Volatility as measured by standard deviation (the dispersion of outcomes around "the mean," or average result). When the standard deviation is lower, realized results tend to be closer to expected results (and vice versa). Standard deviation is not intended to reflect the entire range of gains or losses possible from an investment.

INDEX DEFINITIONS

US BONDS: Barclays Capital US Aggregate Bond Index – Covers the US Dollar-denominated, investment-grade, fixed-rate, taxable bond market of SEC-registered securities. The index includes bonds from the Treasury, Government-Related, Corporate, MBS, ABS, and CMBS sectors.

COMMODITIES: Bloomberg Commodity Index - A broadly diversified index of futures contracts intended to be representative of the commodities market. It currently includes 19 commodity futures in seven sectors.

MUNICIPAL BONDS: Barclays Capital Municipal 1-10 Year Index - Tracks the broad market performance of tax-exempt bonds with 1 to 12 years remaining to maturity.

10-YEAR US TREASURY BONDS: BofAML US Treasury Current 10 Year Index – The market value weighted index of public obligations of the US Treasury with maturities of 10 years.

INT'L DEVELOPED EQUITIES: MSCI EAFE Index - A free float-adjusted market-capitalization index that is designed to measure developed market equity performance, excluding the US and Canada. Consists of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the United Kingdom.

EMERGING MARKETS EQUITIES: MSCI Emerging Markets Index - A free float-adjusted market-capitalization index that is designed to measure equity market performance in the global emerging markets. Consists of the following 25 emerging market country indices: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.

US LARGE CAP EQUITIES: Russell 1000 Index - Measures the performance of the large-cap segment of the US equity universe and represents approximately 92% of the US market.

US SMALL CAP EQUITIES: Russell 2000 Index - Measures the performance of the 2,000 smallest companies in the Russell 3000 Index, representative of the US small-capitalization securities market.

LIQUID HEDGE FUNDS: HFRX Global Hedge Fund Index – A daily-valued index designed to be representative of the overall liquid hedge fund universe. It is comprised of all eligible hedge fund strategies; including but not limited to convertible arbitrage, distressed securities, equity hedge, equity market neutral, event driven, macro, merger arbitrage, and relative value arbitrage. The strategies are asset weighted based on the distribution of assets in the hedge fund industry.

ILLIQUID HEDGE FUNDS: HFRI Fund Weighted Composite Index – A global, monthly-valued, equal-weighted index of over 2,000 single-manager funds that is designed to be representative of the overall composition of the hedge fund universe. It is comprised of all eligible hedge fund strategies. Constituent funds report monthly net of all fees performance in US dollar and have a minimum of $50 Million under management or a twelve (12) month track record of active performance. The HFRI Fund Weighted Composite Index does not include Funds of Hedge Funds.

GLOBAL REITs: FTSE EPRA/NAREIT Developed Real Estate Index - A measure that tracks the performance of listed real estate companies and REITs worldwide.

DIVERSIFIED PORTFOLIO: 10% US Municipal Bonds; 10% US Core Bonds; 25% US Large Cap Equities; 5% US Small-Cap Equities; 22% Int'l Developed Equities; 9% Emerging Markets Equities; 4% Global Infrastructure; 13% Illiquid Hedge Funds; 2% Commodities.

ABOUT LAIRD NORTON WEALTH MANAGEMENT

With nearly $6 billion in assets under advisement, Laird Norton Wealth Management is the Northwest's premier wealth management company. Founded in 1967 to serve the financial management needs of the Laird and Norton families, the firm now provides integrated wealth management solutions to more than 700 individuals, families, business leaders, private foundations and nonprofit organizations.

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A benchmark is an unmanaged index, and its performance does not include any advisory fees, transaction costs or other charges that may be incurred in connection with your investments. Indices are statistical composites and are shown for informational purposes only. It is not possible to invest directly in an index. Indices are unmanaged and are not subject to management fees. Any benchmark whose return is shown for comparison purposes may include different holdings, a different number of holdings, and a different degree of investment in individual securities, industries or economic sectors than the investments and/or investment accounts to which it is compared. Comparisons of individual account or portfolio performance to an index or benchmark composed of indices are unreliable as indicators of future performance of an actual account or portfolio. Actual performance presented represents past performance net of investment management fees unless otherwise noted. Other fees, such as custodial fees or transaction related fees may not be reflected in the actual performance results shown.

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