

The Guardian Insight

Timely Perspectives from the
GCA Investment Committee

May 28, 2010

What does RISK mean to you?

Personalizing & Understanding Risk

The word 'risk' is a staple of every investor's lexicon. Yet many would be hard pressed to define what risk really means to them. With some coaching, experienced private client advisors can help clients identify what risk truly means for their own personal circumstance.

Some Ways of Looking at Risk

Risk to those in the investing profession is often referred to as volatility or the frequency and magnitude of changes in asset values. Some subcomponents of risk that create this volatility are currency risk, political risk, country risk and company specific risk.

Perhaps more germane to an investor is the reality that finite working lives and typically limited resources means that they have to be very aware of what permanent losses to their assets might mean for their retirement or other capital spending goals. As well, the 'hidden' costs of taxes and inflation can qualify as risks if one's money doesn't grow at a fast enough rate. Earning high enough returns to get ahead of the effects of inflation & taxes and to grow one's assets to create real wealth is critical and is balanced by the desire to avoid permanent capital losses and to keep the short-term downside of a portfolio to a minimum.

Complicating things is the fact that the negative feelings we get from having our

assets decrease in value are much more intense than the elation we feel when asset values increase. This indeed seems logical because increases in assets allow you to continue to live as you are, where as a decrease may mean a cut to your standard of living.

But why does this matter? If one believes that over time economies will grow and stock markets will rise, then they naturally should simply participate in them without reservation. But clearly, if a short-term downturn in the value of one's portfolio causes them to sell some or all risky assets at below rational prices, then they certainly won't be able to participate in the long-term benefits of the growing economy and the markets.

A critical task for an investor or advisor is to know how much downside one can tolerate (and obviously not construct a portfolio that will go to that 'trigger' level). Unfortunately, there are no magic formulas that allow someone to know in advance exactly how much downside will trigger that "I can't take it anymore" response. Probing questions, an analysis of previous reactions to market downturns and consideration of other life experiences are some of the tools to help an advisor estimate the amount of 'pain' a client can withstand.

Being mentally prepared for 'worst-case scenarios' is a good way to deal with negative short-term market movements. We have analyzed the long-term histories of the annual return profile for various types of portfolios.



**GUARDIAN CAPITAL
ADVISORS LP**

PRIVATE WEALTH MANAGEMENT GROUP

TRUST - TRANSPARENCY - CONTROL

VANCOUVER CALGARY TORONTO

Head Office: Commerce Court West . Suite 3100 . PO Box 201 Toronto . Ontario . M5L 1E8 General : (416) 947-3747 . Toll Free : 1-800-253-9181 www.gcaweb.com

The Guardian Insight

Timely Perspectives from the
GCA Investment Committee

May 28, 2010

What does RISK mean to you?

While history certainly doesn't exactly repeat itself, we can create a rough guideline as to how things could play-out in the future by studying the past. For instance, (and with all of the usual caveats) a balanced portfolio of stocks & bonds over the last 84 calendar years has experienced down years (negative returns) roughly 1 in every 4 on average. Over this period there were two back-to-back declines and one set of three consecutive yearly declines. The most severe negative return was in 1931.

It is often said that a picture is worth a thousand words, so we can also show clients an actual picture of what the return profile looked like for various portfolios. And though there are no guarantees, it helps the client build perspective. While the year 2008 was not fun from an investment perspective by any stretch, as we went through it with clients and showed them that indeed things had been worse in history and still managed to come back, this gave them some degree of comfort.

The Icy Road of Investing

A favorite analogy of ours is to ask a client whether they thought driving at high speeds down an icy mountain road to get your son or daughter to a hockey game on time was a good idea. Clearly the answer is no as the risk of a life doesn't compare to playing a game. Similarly, we show clients that when others invest with these types of 'risky' strategies, and even though a certain low

percentage do indeed make it to the proverbial 'hockey game' on time, it does not mean that it was/is the appropriate strategy to take. In other words, a positive ex-post outcome does not always mean that the ex-ante decision was sound.

A great example of this is the S&P/TSX (Canadian stock market index) where approximately 50% of the assets in the Index are in the higher risk (volatile) materials and energy categories. Does it really make sense to build a portfolio that has nearly 50% in two risky sectors? What if the TSX was 95% resources – would we continue to build portfolios that mimicked the index? Likely not.

Human nature is such that we can't help but compare what 'we' have to what our neighbor/colleague/sibling/etc has. What is almost always lost in these comparisons is an evaluation of what the needs, risk tolerances, assumptions and strategies used by the comparable were.

We typically report to a client what their return is versus a blended market benchmark, as well as versus a real-return (inflation adjusted) benchmark. By doing so, we believe that we can help our clients understand that the returns that they need to say, retire, are separate from what the markets are doing. Imagine a conversation between an advisor and a client after 10 years of returns. The advisor is beaming because they've 'killed' the market benchmark by 5%/year. Unfortunately, the client is not so happy because while the market



**GUARDIAN CAPITAL
ADVISORS LP**
PRIVATE WEALTH MANAGEMENT GROUP

TRUST - TRANSPARENCY - CONTROL

VANCOUVER CALGARY TORONTO

Head Office: Commerce Court West . Suite 3100 . PO Box 201 Toronto . Ontario . M5L 1E8 General : (416) 947-3747 . Toll Free : 1-800-253-9181 www.gcaweb.com

The Guardian Insight

Timely Perspectives from the
GCA Investment Committee

May 28, 2010

What does RISK mean to you?

was down 8%/year and their portfolio was down 'only' 3%/year, they are nowhere near meeting their retirement objectives that required a real positive increase in their wealth ahead of the rate of inflation and taxes.

Much has been written and promoted about sophisticated 'hedge fund' strategies to help clients get all the upside and none (or a smaller portion) of the downside in the markets. While it may be true that these strategies did better on average than the market through this last recession, the fact remains that they did not earn real returns as promised and there are substantial 'tail' risks (a kind way of saying blowing up) with very little transparency to the underlying investments and strategies. There is likely no lasting 'free lunch' out there beyond prudent global diversification.

Indeed what there seems to be a shortage of in the market in general is simply common sense. And as the old saying goes, if it seems too good to be true it probably is.

Common Sense About Where We Are Now

To that end, common sense indeed tells us that we are now in a world economy that faces a predicament of too much debt; both for governments and individuals. And, as every new homeowner knows, when you have a big mortgage, in order to reduce it, you need to spend less and hope for some raises at work. Thus, global growth will

surely slow going forward as the collective debtors attempt to pay down the proverbial 'mortgage'. As well, governments are the holders of much of the debt and their 'raises' will come in the form of higher taxes. Slower growth means less profitability overall, which also begets lower valuations (or paybacks) on business assets (stocks). The good news is that as long as investors don't lose complete faith in a government or currency, then to go along with this slow growth is low inflation.

Conclusion

While it is true that risks are always present in the investing arena, there certainly are periods when the downside is much larger than the upside. Knowing when risks are substantial is the key. Even though the exact odds and timing may be unknown, even an approximation is better than willfully ignoring them. And even if the lower probability 'upside' event occurs, it doesn't mean that you or your advisor have made the wrong decision. Rather, it could mean that they evaluated the odds appropriately. Flipping a coin heads-up 10 times in a row doesn't make someone any smarter than the next guy. Outside of the petri dish of a lab, there are very few certainties in life – so have a balanced and common sense approach to risk taking. And especially now, be cautious with your hard earned money, just as we are with our clients' capital, you'll sleep better for it, and likely 'live' better for it too.

**Guardian Capital Advisors
Investment Committee**



**GUARDIAN CAPITAL
ADVISORS LP**

PRIVATE WEALTH MANAGEMENT GROUP

TRUST - TRANSPARENCY - CONTROL

VANCOUVER CALGARY TORONTO

Head Office: Commerce Court West . Suite 3100 . PO Box 201 Toronto . Ontario . M5L 1E8 General : (416) 947-3747 . Toll Free : 1-800-253-9181 www.gcaweb.com