Investment Risk Strategy

By the LNWM Investment Strategy & Research Group

Uncertainty cannot be separated from investment management. Markets cannot be predicted or "timed," nor has anyone been able to accurately forecast systemic events. Assessing and managing investment risk is core to our process at LNWM, both in how we manage portfolios and how we evaluate a manager's investment capabilities.

At LNWM, we engage in two types of investment risk management: (1) defensive, whereby we identify and assess the different levels of risk in the investments we make; and (2) offensive, whereby we make forward-looking decisions about what types of risks are worth taking given the likely return. As with athletic teams, a strong defense cannot compensate for a weak offense, and vice versa; investment portfolios need both types of risk management to succeed.

Taking the Right Amount of Risk

If you're an LNWM client, you know we go to great lengths to make your finances more predictable through cash flow modeling, as well as tax and insurance strategies. Investing is different, however. Our aim there is not zeroing out your risk; we believe you have to take on some risk to keep your assets growing over time.

Here at LNWM, our focus is 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 prices move together (or not), and "what if" scenario analysis, both before and after we invest.

Take a 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) aconsistent 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?

Why We Manage Risk

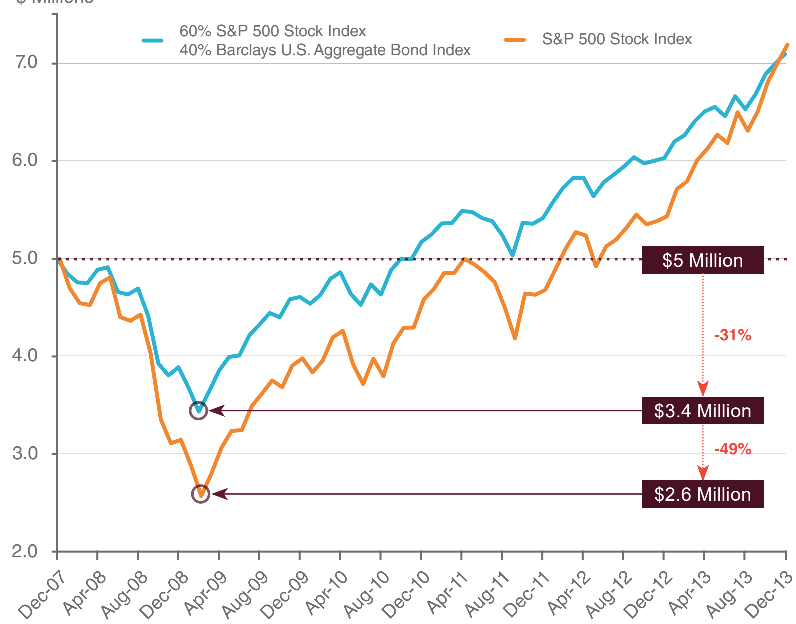
It may seem counterintuitive, but we find that lowering portfolio risk to moderate levels usually leads to higher long-term returns for two reasons:

#1. Lower Risk Means Lower Price Volatility.

With lower volatility, the cash flow from your investments is likely to be more reliable. You're also 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 at right, which shows a higher-volatility portfolio invested in the S&P 500 vs. a less-volatile blend (60% stocks/ 40% bonds), since 2008. Higher-risk assets such as stocks do tend to outperform in the long run. But ask yourself: Could you sit still if your $5 million all-stock portfolio were valued at $2.6 million? A lower-volatility portfolio makes it more likely you'll stay invested for the long run while maintaining a more reliable cash flow.

$5 Million All-Stock Portfolio vs. Simple Blend
Total Return 2008-2013



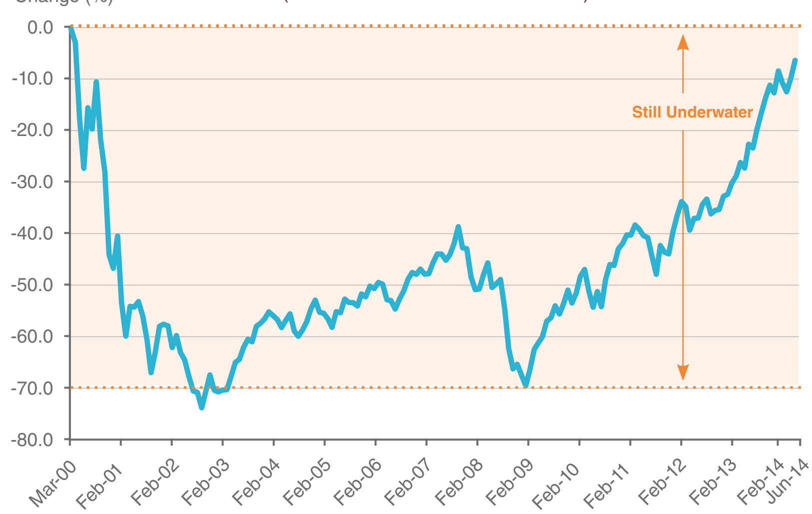
SOURCE OF DATA: Morningstar Direct.

#2. Big Price Drops Can Take a Long Time To Recoup.

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. Worse, a big decline at the end of an investment period can dramatically lower your realized return.

Take a look at the chart at right of the NASDAQ Composite Index, comprised of technology and other growth stocks. The NASDAQ has yet to fully recover from two plunges to the -70% level since 2000.

NASDAQ Composite Stock Index
(Since March 2000 - June 2014)



SOURCE OF DATA: Morningstar Direct.

How We Manage Risk

LNWM targets and maintains specific levels of portfolio risk; then we attempt to maximize returns within those levels. This is possible because each asset category (various types of stocks, bonds, etc.) has unique risk/return characteristics that we use in combination to lower risk to a specific level, while still allowing for targeted rates of return.

Our building-block approach, which is based on asset-allocation modeling and testing, allows us to draw on the strengths of each asset category while minimizing its shortcomings. We see 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.

We manage risk by calibrating risk. Our risk metrics are based on price volatility, the industry norm. But we don't stop there. LNWM's Investment Strategy & Research team runs thousands of simulations to test the risk/return assumptions for the asset allocations used in client portfolios. This gives us insight into: (1) the worst likely returns; and (2) the likelihood of various levels of loss in any one year.

Risk Management for the 21st Century

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, we have been adding carefully selected alternative assets, such as hedge funds and managed futures, to client portfolios as warranted. The benefits are twofold:

1. The returns on alternative assets are less correlated with traditional assets like stocks and bonds, providing necessary diversification; and
2. Alternative-asset managers can use a variety of strategies to limit losses during massive market disruptions and downturns.

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