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The wise rich know about risk

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Serious investors focus first on risk by defining acceptable downside measures.

You can't manage what you can't measure. Thoughtful wealthy investors have learned this adage applies to managing investment capital as much as it applies to running a business. If meaningful benchmarks and other investment measures aren't defined at the outset, managing the family money can turn into an emotionally driven series of ad hoc actions and reactions that almost guarantee unwelcome costs and taxes on top of disappointing returns.

Capital preservation is the No. 1 goal of the wealthy; the pain of sliding down the lifestyle ladder is infinitely greater than the pleasure of climbing it. Hence, serious investors focus first on risk by defining acceptable downside measures. In a recent discussion I had with a savvy family on the design of their portfolio, their concern was setting the level of volatility they would be comfortable with and identifying the reasonable worst-case loss the portfolio could suffer in a serious bear market.

Maximum exposure to any single manager is another important risk measure. When I worked in Los Angeles, one of my partner's friends was a billionaire who had to cut back his investment with a famous hedge-fund manager to keep within his exposure limits. Although this can be difficult to do when times are good, it paid off: Over the past two years, this particular manager reportedly suffered deep, painful losses.

Liquidity is another key risk metric. Investors should specify how much cash they need to keep on hand and what portion of their portfolio can be allocated to illiquid investments or funds that can suspend redemptions.

Absent specific risk parameters, it is easy to fall into the trap of letting the latest hot sector or manager become the implicit measure of success. I have talked to many investors who gradually took on more portfolio risk as they added more micro-and small-cap stocks and funds to their portfolios in 2006 and 2007. They were lured in by sizzling returns. The nearly 80% decline in the S&P/TSX Venture composite index from its peak in 2007 to the spring of this year was a pail of cold water that awakened them to the true level of risk they had assumed.

Defining risk limits at the outset helps keep an investor on course during hot markets and cold.
The expected portfolio return should also be defined. This number is derived from the asset mix and risk profile, since it is risk that drives returns. At minimum, expected returns should be over the six or so years that comprise the average business cycle.

By defining explicit risk and return measures that reflect their unique situations, investors are emulating the best practices of leading institutional investors. Yale Endowment, for example, annually publishes the expected return and volatility of its portfolio.

Actual results are then measured against the return and risk benchmarks. Success or failure is easy to measure, fully transparent and, most importantly, absolutely personalized.

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