

Two Critical Lessons from Japan An End-of-Quarter Letter to Clients

By Dan Richards
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Given recent events in Japan and North Africa, many clients are looking to their advisors for direction on what they should do.

This template for an end-of-quarter letter is intended to be a starting point for your letter to clients. One note of caution – to be effective, it has to reflect your approach, personality and point of view. Be sure to take the time to customize the letter to your own situation.



Two critical lessons from Japan

“The only certainty is that nothing is certain”

Pliny the Elder

First century Roman author and naval commander

“It ain’t what you don’t know that gets you into trouble.

It’s what you know for sure that just ain’t so.”

Mark Twain, 1835-1910

At the end of each quarter, I send clients a letter summarizing events of the past three months ... and usually try to find a relevant quotation to establish the tone for my note.

For this quarter’s letter, I have selected quotes written nearly two millennia apart to highlight two important lessons for investors. Both were made tragically apparent by the recent events in Japan. One is the need to construct portfolios that expect the unexpected and anticipate the unanticipated. And the other is to avoid one of the costliest traps that ensnares investors.

Before getting into detail on those lessons, here’s a quick recap on the first quarter.

Market performance in the first quarter

Markets in January and February reflected a continuation of last year’s positive sentiment. This was spurred by solid corporate profits and a broad consensus that, while the global economy might not experience a strong recovery going forward, it would see growth.



March began with a setback. The earthquake and tsunami in Japan on March 11, which took a dreadful toll in human lives, clearly reduced short-term prospects for the global economy. The turmoil in North Africa, while positive for oil prices, also had a negative impact on markets due to concerns about the effect on consumer demand. By the end of March, however, positive economic growth reports in the US and Europe allowed most markets to recover their initial losses.

As a result, developed markets generally saw gains at the end of the first quarter that put them on track for solid performance in 2011. Below are first quarter results for key markets – of note, results outside of the US were boosted by the weak dollar – for example, first quarter gains in Europe were 6% in dollar

% change (all in \$US)

	US	Europe	Japan	Emerging Markets	World Markets
January	+2.4%	+4.0%	+/-0%	-2.8%	+1.6%
February	+3.3%	+3.3%	+4.6%	-1.0%	+2.9%
March	+/-0%	-0.8%	-9.1%	+5.9%	+/-0%
First quarter	+6.0%	+6.6%	-4.5%	+2.1%	+4.5%

Source: MSCI

Learning to live with uncertainty

If they operated efficiently, stock and bond markets would incorporate all the available information at a given point in time. That’s why when sovereign debt problems emerged in Greece early last year, other European countries seen as having potential problems along the same lines faced an immediate spike in the cost of insuring their debt. Even though they hadn’t run into problems yet, the market factored in this possibility.

Market analysts spend many thousands of hours each year on these kinds of issues - with enough time and research, slow-forming issues like government debt problems can be identified before a crisis unfolds.

What can’t be anticipated are developments that are by their nature unpredictable. We’ve had at least four such events in the past year:

- Last April’s volcanic eruption in Iceland that spewed ash in the air, shut down 100,000 transatlantic flights and cost the airline industry \$2 billion;
- Also last April, the explosion of the Deepwater Horizon oil rig in the Gulf of Mexico;
- Commencing last December, street protests resulting in changes of leadership in a number of countries in North Africa, leading directly to the current war in Libya; and
- Of course the, earthquake, tsunami and nuclear-reactor crises in Japan.



In light of episodes like these, investors need to take away two key lessons.

Lesson one: Expect the unexpected

The only way to deal with uncertainty and manage the impact of unforeseen events is to build strict risk controls into portfolios, similar to those used by the most sophisticated pension funds. While the risk of one-time incidents can't be eliminated, through diversification and risk management we can limit the damage when negative events occur - whether they are massive frauds such as Enron, sudden bankruptcies like Lehman Brothers, volcanic eruptions, oil rig explosions or earthquakes.

Here's an overview of my approach to risk management in portfolio construction. There are three steps in this process.

Step one: Identify target mix

First, we identify the target mix of stocks, bonds and cash that, based on historical precedent and current valuation levels, will over time have a high likelihood of providing the returns you need to achieve your long term goals with a level of volatility you can live with along the way.

Step two: Diversify

Next we and the money managers we work with carefully diversify your portfolio, by placing limits on the exposure to any one company, industry sector or region. For individual holdings, it's typically an absolute percentage of your portfolio – so for example no one stock should make up more than 5% of your equity holdings, and no one bond should represent more than 3% of your fixed-income exposure.

As well, no matter how optimistic we are about an industry sector or region, its weight should never be more than 50% above its underlying importance in the market as a whole.

Step three: Stay balanced

In the final step, at least once a year we conduct an in-depth analysis of each portfolio. Over time, asset classes, industry sectors and individual stocks that do well will increase their presence in your portfolio and bump up against the risk-control limits. At that point, your portfolios need to be rebalanced back to the target asset allocation and some of the positions that have outperformed might be trimmed to stay within risk-control limits. Some investors find this very difficult – after all you're selling exactly those investments that have done the best.



But it's the only way to stay truly diversified and control the risk that accompanies overexposure to any one stock, industry sector or geographic region. And it's also the only way to get some protection from things that simply can't be anticipated.

Lesson two: Avoid overconfidence

Aside from the time entailed, there is one big negative to the risk-controlled approach to portfolio construction – in the short and mid-term, there will always be someone who's made a big bet that's paid off and who is doing better than you as a result. Because it eliminates big bets, a risk-controlled approach to investing will seldom give you bragging rights on the golf course.

Investors who take the big-bet approach typically have a high degree of confidence in their investments; after all, if you're absolutely certain about a company or industry, why bother to diversify? On the other hand, research by the University of Chicago's Richard Thaler and others has demonstrated that overconfidence is among the most costly traits an investor can have.

Think no further than the many employees in Silicon Valley during the tech boom who were 100% confident about the future of their firms and had all of their retirement accounts invested in the companies they worked for as a result. They saw sterling results for a while – right until the tech bubble collapsed.

The quote from Mark Twain at the start of this letter says it all – what gets us in trouble aren't the things we've identified as question marks and causes for concern. Rather, portfolios crater because of the things that we're absolutely positive about – right until unanticipated occurrences catch us by surprise.

We've always had unexpected events and always will – and despite these, economies have grown, companies have prospered and stock markets have generated positive returns. The key to benefiting from this long-term growth has been to diversify so that no single event can create permanent damage to portfolios. When it comes to long-term investing, it's not only that a slow and steady approach wins the race, but more importantly slow and steady survives to cross the finish line.

We will work through the recent events– and investors with a balanced approach and a long-term view will be well rewarded. The approach to risk management I've described may not be fun or sexy in the short term, but all the evidence at hand suggests that over time it will serve you well, getting you to your goals with the least amount of stress and distress along the way.

At our next meeting, I'd be happy to discuss the impact of rebalancing on long-term returns. Should you have any questions in the meantime on your portfolio, the contents of



this note or any other issue, please give me a call – I'd be happy to deal with your questions on the phone or at our next meeting.

As always, thank you for the opportunity to work together.

Best regards,

Name of advisor

[Dan Richards](http://www.clientinsights.ca) conducts programs to help advisors gain and retain clients and is an award winning faculty member in the MBA program at the University of Toronto. To see more of his written and video commentaries, go to <http://www.clientinsights.ca>. Use A555A for the rep and dealer code to register for website access

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