



ASSET MANAGEMENT COMPANY

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SPECIAL TAX PROFESSIONAL ISSUE

### ***RISK MANAGEMENT***

In the last few years, as a result of a cooling economy and a challenging securities and real estate market, most tax professionals have seen their clients' portfolio risk firsthand. If your clients express concern to you, we thought that it might be timely to offer you a few tips on how to identify and help manage any excess risk that your clients may have.

In considering your clients' risk exposure, we believe a number of factors play an important role. Among those factors are how concentrated your clients' assets are at both the asset and asset class level; the appreciation potential of the clients' investments; and finally, who advises your clients on investments, how they are compensated for their advisory service, and their level of competence.

### ***CONCENTRATED POSITIONS***

Many people earn great returns through concentrated positions in specific securities or sectors. These positions usually arise through a client's own research and risk preference, through an inheritance or by an entrepreneurial initiative. There is absolutely nothing wrong with holding concentrated positions as long as the investor understands and is comfortable with the additional risk. In fact, an advantage to concentrated positions are that they may offer the investor control or substantial influence over the issuer to help mitigate his or her risk. However, an important cost of a concentrated position is the lost opportunity of returns from other, perhaps, more attractive

investments. In addition, a client's life circumstance such as divorce, retirement, or illness, may warrant hedging some or all of a client's concentrated position. There are many ways to do this without incurring current taxes, including exchange funds or derivative hedges, however, simple risk management may justify the outright sale of a concentrated position. For your practice, it is important to be aware of positions that comprise over 30% of your client's assets and to raise the question as to whether a risk management policy is in order.

Finance theory and research shows that most of the firm-specific risk (sometimes called unsystematic risk) can be diversified away with a portfolio of 20 stocks or greater. However, in practice, transaction costs may have a material impact on constructing such a portfolio, therefore diversified products such as mutual funds, exchange traded funds (ETFs) or unit trusts may be substituted. Determining the amount of a concentrated position to eliminate through hedging or sale is more art than science and how to do it depends on your client's tax situation and risk tolerance. Your coordinating with the client, their legal advisor (in the case of restricted securities), and an independent investment advisory firm may bring consensus on how to best structure such a transaction in the client's best interest.

Sector concentration is another area where your client may underestimate risk. In the frenzied market of 1998 through 2000, many investors placed

concentrated bets in the technology sector. We also see many portfolios that have heavy investments in oil and gas issues. The incremental risk comes from the supply and demand dynamics for sector-specific products, the number of market participants, the economic profit potential and the sector growth rates. This layer of risk exists in those portfolios that have sector over-weighting.

#### **VALUATION RISK**

Another area where risk can be uncovered is in the disparity between security prices and the underlying value. Determining a security's value is a difficult task, and again, is more art than science, but a few tips may help. Bond values are straightforward as they are priced at the present value of future cash flows. When you start to add elements of uncertainty such as credit deterioration, it becomes more difficult. We believe that the same valuation method applies to stocks as well, but there are far more sources of uncertainty. However, at the end of the day, stocks should be valued as the present value of cash flow to the equity investor. This requires a cash flow model and the use of well-thought-out assumptions for growth rates, profitability, capital expenditure, net working capital investment, tax rates, capital structure and cost of capital. We believe this is a far superior method than relative valuation measures such as price-to-earnings, or price-to-sales ratios.

Many investors may believe that attractive relative values, such as a low P/E, may make an investment attractive because, on average, the rest of the market trades at a higher P/E. For example, if I buy

a stock with a P/E of 15, it might be cheap because the rest of the market trades at a P/E of 24.

The problem with this assumption is that we don't know what a fair P/E ratio for the rest of the market really is, because to a large extent the market's current P/E is a function of liquidity, not underlying value. In addition, my 15 P/E stock may have a lower P/E for reasons that make it quite expensive at 15. Moreover, the E in the P/E equation may be of low quality or even fictional, as Enron investors painfully discovered.

Valuation multiples, in general, provide an apples-to-oranges comparison because of differences in industry economics, operational structure, and accounting methods. The variable mean of valuation multiples is another major problem in using them. For example, if all Internet stocks trade with a price-to-sales multiple of 7, and I buy one with a multiple of 5, is mine cheap? The answer is no because the absolute value is excessive as a result of investor speculation. This makes future returns reliant on predicting investor preferences, which has a high probability of ultimately failing. We believe that a better strategy is to determine a security's value, invest in those that are under priced, and to let time provide the return. An independent advisory firm can help estimate the absolute value, hence the risk, of securities.

#### **ADVISORY RISK**

This is the risk of receiving and acting upon low-quality advice. This risk exists for any investment advisor, but can be mitigated in several ways. One



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way is to recommend that the client use an independent advisor. Many operators in the investment advisory business are paid for distribution. In other words, how much of Mutual Fund X, or how many transactions are generated determines their compensation level.

This provides for a misalignment of interests with their customers. In addition, the investment recommendations to which many advisors have access are frequently biased because the recommendations pertain to corporate finance customers of the advisory firm. While the research may be of good quality, the end client never really knows if the opinion is truly objective.

Another way to mitigate advisory risk is to recommend that your clients interview multiple managers to find one that is competent and with whom the client is compatible. Competence can be measured (to some extent) by the advisor's experience level, educational background and professional accreditations. Compatibility, on the other hand, is difficult to know at the outset, other than in a general agreement in investment philosophies.

We hope that the content of this article helps you in your practice. Financial security is the cornerstone to your clients' quality of life and we believe that tax professionals are a key element to providing it. Please feel free to call Obermeyer Asset Management Company at (970) 925-8747 if we

can assist you further in identifying your clients' exposure or help you in developing an effective risk management program.