



Managing risk in volatile markets

How mutual fund managers "manage" investment risk

There is nothing more discouraging than watching your investment portfolio fall in value. The recent challenges associated with the U.S. housing market, the high cost of energy and a slowing U.S. economy have inflicted a heavy toll on global markets, and many investors are nervously waiting for the day when confidence returns.

If you have invested in mutual funds, the good news is that you have hired a team of investment professionals who have been trained to manage certain types of investment risk. Unlike index funds, which simply track market indices, actively managed mutual funds can benefit from a number of tools and strategies that aim to protect investors' capital.

THE TOOLS OF THE TRADE

Mutual fund managers use a number of different approaches to help protect valuable investment capital, while they pursue long-term investment growth. Here are some of the most common ones.

DIVERSIFICATION

Diversification is a strategy many investors are already familiar with. It's best summed up by the colloquial saying, "Don't put all your eggs in one basket." Mutual fund managers may spread the capital of a mutual fund across a number of different companies, sectors, geographic regions and asset classes (such as stocks, bonds and cash equivalents). The rationale behind this strategy is that a portfolio of different kinds of investments will, on average, reduce risk given an expected level of return.

Mutual fund managers have discretion about how many securities they can hold in a portfolio. For example, some mutual funds may hold as many as 200 different companies, while others limit themselves to between 35 and 60 companies to create a more concentrated portfolio.

Whatever the specific approach, a mutual fund manager's ability to provide instant diversification to investors, both inexpensively and efficiently, may be the most important way mutual fund managers help control risk.

FUNDAMENTAL AND QUANTITATIVE ANALYSIS

Fundamental and quantitative analysis are complementary strategies that can help mutual fund managers further control investment risk.

Fundamental analysis involves analyzing a company's financial statements to evaluate its management team, competitive advantages, competitors and markets. Analysts examine both historical and present data to make financial forecasts. The end goal is to determine a value for the stock so the mutual fund manager can compare it to the security's current market price in the hope of either making a profit or avoiding a loss in the future.

Quantitative analysis exploits complex mathematical and statistical research to help mutual fund managers understand market behaviour. It enables the measurement, performance evaluation or valuation of a security and can also be used to help predict the future performance of a security, including changes in share price.

Using the sophisticated tools of fundamental and quantitative analysis, mutual fund managers seek to identify trends within a company early enough to either profit from a rise in value or avoid participating in a decline in the stock's price.

ASSET ALLOCATION

Asset allocation describes how a mutual fund's assets are allocated among stocks, bonds and cash. Even equity mutual fund managers often invest some of their fund's assets in either bonds or cash-equivalent investments, although they may face restrictions on how much of their portfolio can be allocated to these less volatile securities.

Depending on the specifications of a fund's prospectus, an equity fund manager may be required to keep a fund's entire portfolio invested in equities, or he or she may have the flexibility to move some of the fund's assets into bonds or money market securities in response to volatile markets. Therefore, it is important to review a fund's prospectus carefully and research the track record of the fund manager.

The ability of a fund manager to move assets into cash can be an effective means of protecting investment capital during volatile markets. Equity funds can also use their cash positions to reinvest in the markets when stocks are cheaper. This flexibility to move among asset classes as market conditions change is one way mutual fund managers add value when compared to passive investment strategies, such as index funds, that remain fully invested at all times.

INDEX AND SECTOR WEIGHTS

Almost every mutual fund in Canada uses an index as a benchmark to compare both the composition of securities held within the fund and the fund's relative performance characteristics. For example, a mutual fund whose mandate is to invest in Canada's largest



companies would likely use a comparative benchmark such as the S&P/TSX Composite Index.

Indices comprise companies that represent sectors of the economy. The S&P/TSX Composite Index, for example, contains companies from a number of different sectors, but is dominated by financial services corporations, such as banks and insurance companies, and natural resource companies that produce oil and gas, thus reflecting the concentration risks of the Canadian market. Mutual fund managers can help to minimize these concentration risks by underweighting financial, materials and energy stocks in their portfolios and shifting assets into other sectors.

In fact, mutual funds are often either “underweight” or “overweight” in certain sectors of the economy when compared to their benchmark index. For example, if a mutual fund holds 20 per cent of its assets in financial stocks, and financial stocks comprise 25 per cent of the underlying index, the fund is considered “underweight” in financial stocks because it holds five per cent fewer financial stocks than its benchmark.

Unlike index funds that simply track the value of an underlying index, mutual fund managers can also underweight or overweight a portfolio based on the outlook for sector performance. In the current market, many mutual fund managers might decide to underweight financial stocks in their portfolios in the belief that the sub-prime mortgage crisis has not yet run its course. Overall, the ability to either underweight or overweight a portfolio gives mutual fund managers a powerful tool to help control risk that passive investment strategies simply do not share.



COMPANY WEIGHTS

Many prospectuses stipulate that no more than five or 10 per cent of a mutual fund’s assets can be invested in a single stock. This restriction limits the fund’s exposure to company-specific risk.

An excellent example of how this strategy can help to protect investment capital occurred in September 2000 when, at its height, Nortel Networks accounted for 36.5 per cent of the total valuation of all the companies listed on the Toronto Stock Exchange. When Nortel’s market capitalization fell from \$417 billion in July 2000 to \$5 billion in August 2002¹, many investors holding index funds experienced a huge impact to their portfolios since they were overly exposed to the fortunes of a single company. While many actively managed mutual funds were also hurt by the sell-off, many mutual fund managers were able to limit the impact by keeping their exposure to Nortel considerably lower than the company’s representation in the index.

CURRENCY HEDGING

Mutual fund managers also have the ability to control the risks associated with investing in foreign securities denominated in other currencies. When a fund invests in a foreign company, it must account for two types of price movements: the price of the company’s stock and the fluctuating value of the currency. Some mutual

¹ MFC Global Investment Management

fund managers use derivatives to help address the risk that the value of a foreign currency will rise (or fall), causing the value of the investment to fall (or rise) in tandem – even though the stock’s price may not have changed.

There is some debate among mutual fund managers as to whether currency hedging is an effective strategy for controlling risk. For global portfolios holding a wide range of foreign currencies, the cost of hedging may outweigh the benefits. Multiple currency exposures in global portfolios may actually provide some diversification benefits. Furthermore, price movements in foreign currencies are notoriously hard to predict and the ongoing cost of hedging a currency must be taken on by the fund’s investors. However, country-specific portfolios with exposure to a single foreign currency may have a stronger rationale for hedging, since the portfolio’s returns can be negatively impacted by a single risk factor.

SPEAK WITH YOUR ADVISOR

If you remain apprehensive about the effects of market volatility on your portfolio, discuss your concerns with your advisor. He or she can do a thorough review of your current holdings and recommend any changes that might be required.

During your review, be sure to speak about your preference for mutual funds with strong track records of risk-adjusted returns. These funds have the potential to provide you with superior long-term growth while minimizing potential risks. There are a number of mutual fund managers who are recognized for their ability to weather market volatility. Your advisor can identify them for you and determine whether the funds these managers oversee may be suitable additions to your current financial plan.

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