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November 2015

Three Key Investment Strategies Hidden in Plain Sight

Plain Sight Strategy #2: Manage Market Risks!

In our last piece, we described why most investors should ignore the never-ending onslaught of unpredictable financial news and tend to three strategies that can be much more readily managed – at least once you know they are there. Hidden in plain sight, these potent strategies include:

1. Being there
2. **Managing for market risks**
3. Controlling costs

Plain-Sight Strategy #2: Managing for Market Risks

Don't take on more risk than you must.

There is no getting around the fact that the market does not deliver rewarding returns without periodically punishing us with realized risks. That is why it's so challenging for most investors to "be there," consistently capturing available returns by remaining invested over time. It's also why it's vital to avoid taking on more risk than you must in pursuit of your personal goals. For this, we have two powerful tools at our disposal, best used in tandem.

Diversification: Eliminating Unnecessary Risk

Diversification helps you spread your risks around. If you instead concentrate your portfolio in too few holdings, sectors or geographical locales, you may feel you've made smart selections when they happen to be doing well. But when bad news hits an undiversified portfolio, it often arrives without warning, and with a vengeance. That's a real risk that investors too often ignore at their own peril.

For example, sometimes, tech stocks are red hot; sometimes domestic securities may seem safer than international choices – or vice-versa. Your company's stock or a popular IPO (Initial Public Offering) may seem like a sure thing. But by trying to position yourself to catch the next trend or dodge some bad news, you're also accepting the risk that your "sure thing" may fail you.

Decades of academic inquiry has informed us that, despite the risks, there are no extra returns expected by trying to consistently predict individual winners and impending losers. Instead, you are best off eliminating this form of risk by putting diversification to work for you.

Asset Allocation: Minimizing Unneeded Risk

While some risks can be diversified away, some remain. These are expected to enhance your long-term returns if you build them into your total portfolio, ***and if you stay the course with them over time.*** They include a handful of factors, categorized into asset classes such as:

1. **Equity** – Stocks (equities) have returned more than bonds (fixed income).

2. **Size** – Small-company stocks have returned more than large-company stocks.

3. **Value** – Value companies (whose stocks appear to be either undervalued or more fairly valued by the market) have returned more than their growth company counterparts.

4. **Term** – Bonds with distant maturities or due dates have returned more than bonds that come due quickly.

5. **Credit** – Bonds with lower credit ratings (such as "junk" bonds) have returned more than bonds with higher credit ratings (such as government bonds).

By blending a customized mix of riskier and less risky asset classes into your portfolio, you can seek to build wealth toward your personal financial goals while fine-tuning the risks involved. In contrast, chasing returns you don't actually need can result in sacrificing what you've already accumulated if the risk is realized. Why go there?

Diversification and Asset Allocation: Your Double Defense

Investment risks are most effectively managed by using the combined powers of diversification and asset allocation. Many investors believe they are well-diversified when they are not. They may own a large number of stocks or stock funds across several accounts. But upon closer analysis, the bulk of their holdings may represent one or two factors, such as mostly large-company domestic stocks. They may think they are managing their risks through diversification, but by failing to implement appropriate asset allocation, excess risk remains.

If there is such a thing as a free lunch for investors, it's enjoyed by making best use of market risks and expected returns. Diversification helps you eliminate *unnecessary* risk – the kind that is not expected to improve your investment returns to begin with. Guided by your financial goals, asset allocation helps you diversify appropriately to minimize *unneeded* risk and to properly manage the market risks that must remain.

In our next piece, we'll introduce one more plain-sight strategy for investment success: controlling the costs involved.