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Kim Inglis, BCom, CIM

Follow head, not heart

Well-defined strategy is the most important element

Very few investors have come through recent market losses unscathed, but I believe that many huge portfolio losses could have been much less. And it is not about hindsight; it is about planning and rational behaviour.

I recently met with an investor who, completely disillusioned with the markets, had liquidated her entire portfolio. Her advisor had tried to steer her away from such a drastic and costly change, but her mind was made up. Although locking in some very substantial losses, she was comfortable with her decision because she could finally sleep.

That evening I reflected on our discussion, trying to figure out why she was happy after crystallizing losses in excess of \$1 million. It occurred to me that her problem wasn't the markets. No, her angst had been generated by the fact that she didn't have a strategic investment plan with comfort ranges. The absence of strategy allowed extreme excursions in her portfolio and the cumulative emotional impact caused her to react irrationally.

I believe a well-defined investment strategy is the single most important element in achieving financial success. It establishes the checks and balances necessary to keep the portfolio in line and creates the discipline required to remove emotion from the process. Investors must think with their heads, not their hearts.

This is particularly important during volatile periods. Investors thinking with their hearts will follow a falling stock to the very bottom of a bear market "hoping things will improve" rather than taking a rational look

at the situation earlier and cutting their losses. During a bull market they will follow a stock upward "hoping to get a little bit more" until the stock reverses course and all gains are lost.

So, where should you begin? First, you need to examine your portfolio and realistically assess your risk tolerance, establishing the maximum dollar value loss you could withstand in the event of a catastrophic market failure. Once this is set, you will have a percentage range within which your advisor can work. For instance, if you've decided that you cannot endure more than \$100,000 in losses on a \$1,000,000 portfolio, then it cannot lose more than 10%.

Our example uses an overall figure of 10% but the actual range may need to vary according to the stock. For example, you may require wider stop losses, or need specific price points, for some types of growth stocks because they experience wide daily fluctuations.

Knowing your percentage range, you can begin to determine an appropriate asset allocation. If your risk tolerance has indicated that you can only withstand a 10% loss, then you should not be fully exposed in equities. Conversely, if your risk tolerance is much higher, you should have fewer fixed income investments.

In the case of the lady who sold her entire portfolio, this strategy would've reduced both her emotional stress and her losses. In the bear market, exit ranges on all her holdings would have decreased the overall portfolio loss, keeping it within her chosen comfort level. And in the bull market, targeted exit points would've helped to lock in profits.

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As an example, let's look at Royal Bank. It hit an annual high of \$51.50 and is now trading below \$30. This lady originally bought the stock at \$38. Had she set a trailing stop loss on the stock she would have locked in her profits on the way up and sold at no less than \$46.35, clinching a 22% gain.

Another example is the Potash Corporation of Saskatchewan. In less than a year, it went from an annual high of \$246.29 to an annual low of \$61.81; a drop of -74.9%. A well-defined exit strategy would have been prudent in this scenario.

Because markets aren't constant, your strategy can't be static. It should be reviewed periodically to maintain alignment with your objectives and reflect market cycles, ensuring your portfolio is properly positioned and flexible enough to withstand change. No matter what your investing style, a clear game plan is imperative.

Kim Inglis, BCom, CIM is an Investment Advisor. The views in this column are solely those of the author. www.kiminglis.ca