

Financial INSIGHT

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Plan for inevitable market risks

Markets have always moved up and down. The U.S. stock market has historically spent more time going up than down, which is why stocks have long been considered good investments over the long term.

However, abrupt market declines can be unsettling, even for the savviest investors. That is why it is important to understand the nature of risk and market volatility and the ways in which investors can control or hedge their own exposure to risk and volatility. An understanding of risk can help investors best determine how to efficiently manage an investment portfolio.

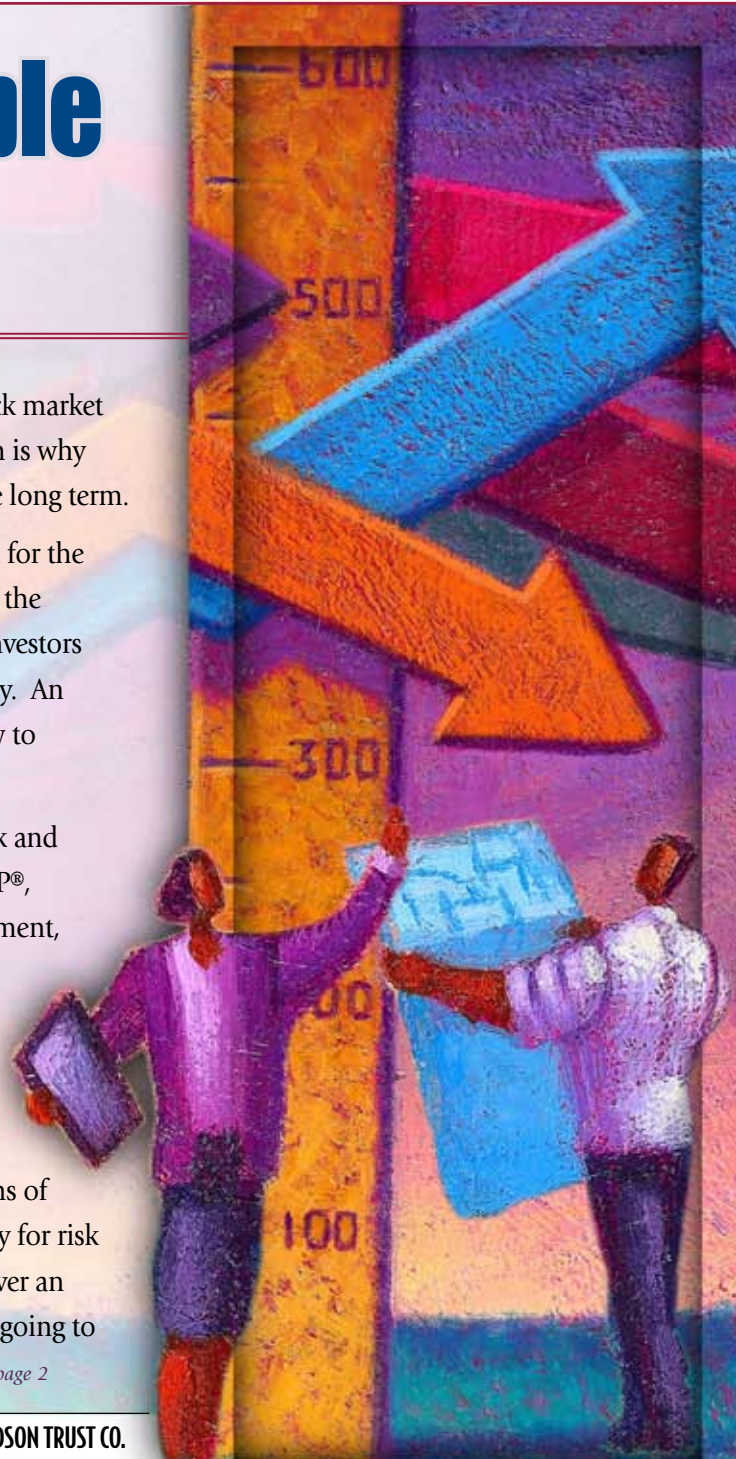
The following is an interview, focused on investment risk and market volatility, with Jim Searles, Senior Vice President, CFP®, Director of Professional Development and Product Management, for D.A. Davidson & Co.

Q. How do you define risk?

It is important to remember that the word "risk" means a lot of things to a lot of people.

Classically, risk is measured by the volatility of the returns of a portfolio. Statistically we use standard deviation as a proxy for risk measurement. If we expect a portfolio to return 8 percent over an extended period of time, we have to remember that it is not going to

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do this in a uniform manner. Some periods will have greater than 8 percent returns, others less. The magnitude of these differences, up and down, is what defines volatility.

Volatility creates some real problems. First, it is uncomfortable. Psychologically it exacerbates all the difficult investment issues.

Negative or downside volatility can hurt people in specific situations. If I have a sum of money that I want to grow at 8 percent over, let's say, 20 years, I don't really care what each year looks like. I just care that over 20 years, my sum has grown by over 4½ times, an 8 percent return. However, if I am looking at withdrawing money, like in retirement, then the pattern of returns is really critical. Early losses can be devastating since the investment loss combined with withdrawals means that your portfolio is diminished such that later, very strong positive returns don't have the same recovery horsepower.

I like to think of risk as the inability to meet your goals. We have to consider not only the returns of the portfolio, but the patterns. As an example, consider your situation if your primary goal is a college education for your child, who is now 10 years old. You have prepared to pay for that education with a stream of investments that presumably has grown in value. Then, one year before your student is to begin college, the value of the portfolio drops by 40 percent. You obviously will not be able to reach your stated goal. Carefully analyze your investment time horizons and the timing of additions and, critically, withdrawals.

Q. What kinds of risk are there?

When you are investing in equities, or stocks, and individual bonds, you face asystematic, or company-specific, risk. When company profits drop or expectations of success decline, the price of the company's stock

will decline accordingly. We as investors can reduce asystematic risk easily by making sure that we don't have a concentration of stocks in one, two or three companies. This is why we emphasize the importance of diversifying portfolios. Academically, a portfolio typically needs to include at least 10 to 20 individual companies to adequately control company-specific risk.

We need also to spread our risk across sectors or industries. At various times, the different sectors in the market have performed poorly even while the overall market is performing quite well. It's very important to not over-weight your portfolio in one or two sectors, thereby exposing yourself to undue risk. Readers might recall the tech boom. If you were heavily invested in technology stocks, you understand the danger of over-weighting in a specific sector.

In addition, we need to consider market risk, which is very difficult to avoid because it involves exposure in the entire market. The reasons for broad market declines include economic or geopolitical forces that touch on the values of stocks across many or all sectors. When there is a broad decline, diversification is not going to save you. When the tide goes out, all ships in the harbor are left behind. This kind of risk is not something you can easily control.

To mitigate the effects of market risk, we must talk about asset allocation, or the percentage of your investment funds that you allocate to the three asset classes: stocks, bonds (or other fixed income investments), and cash (which can also be represented as Certificates of Deposit or money market funds). Ideally, you need a blend of these three classes so that each can act as a buffer for the others during different phases of market cycles. Asset allocation is critically important and may have a

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bigger effect on your long-term returns than the actual securities you choose.

Regular saving and investing is one way to mitigate your exposure to market risk. You can use dollar-cost averaging, or regularly investing a fixed amount of money in an investment or group of investments. This is a disciplined method of investing that allows you to spread your purchases over many parts of the market cycle. It gives you the opportunity to buy some things cheap and to average out the prices you pay for investments. It also has the advantage of taking emotion – that nauseous feeling when you watch the market plunging or the elation you feel when prices start soaring – out of the equation.

Q. *Should we attempt to time the market?*

Timing the market implies that you know when the market is too expensive and will be able to sell at the peak or when you will be able to invest in “bargains” when the market is at a low point. Timing the market has proven to be almost impossible. Someone once said that timing the markets is not what is most important; it’s time “in the market” that matters. That’s true. It’s important to have a rational investment plan based on personal risk tolerances, with an appropriate mix of stocks, bonds and cash. The most appropriate asset mix will depend on a number of things, mainly your financial objectives, investment horizon and your ability and willingness to take risk.

Controlling volatility is largely a result of adding more stable asset classes, bonds and cash, to a portfolio. There is a cost to this; your potential returns are diminished. So we have to strike a posture that balances return and risk correctly. Remember that your circumstances change. Think back to the example of investing to fund a child’s education. At age 16, two years before heading to school,

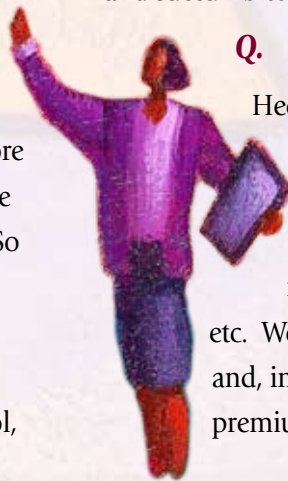
there is not much time to overcome a bad year in the markets. That begins to argue for reducing stock exposure and increasing bond and cash exposure.

Once we have created an investment policy and have achieved the appropriate blend of investments, we need to maintain it. That’s why we suggest making sure that you rebalance your portfolio periodically. The act of rebalancing forces you to mechanically adjust your portfolio and again removes emotion from the equation. For example, you have a mix of 50 percent stocks and bonds. Because of strong market conditions, your stocks’ allocation shoots above 65 percent. When it comes time to rebalance, perhaps once every year, you will sell enough stocks and buy enough bonds to achieve your intended allocation mix. Alternatively, you can rebalance within certain bounds, such as when your portfolio gets out of alignment by 5 percent or so. The periodic rebalancing forces you to sell expensive assets and purchase cheap assets.

Because we tend to fall in love with certain companies and are swayed by news about the markets, it’s important to have rebalancing as part of your investment plan. If you have rebalancing as a stated goal from the beginning, you are less likely to be tempted to try to time the markets and succumb to excess greed or fear.

Q. *Should an investor hedge his or her risk?*

Hedging your risk in investments is the act of placing your bets on the other side. It is much like hedging your risks in other areas of life, such as by purchasing car insurance, life insurance, fire insurance, etc. We need these kinds of hedges occasionally and, in the meantime, we simply pay our premiums. Most investors don’t think to hedge



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their risk in the markets in the same way, but there are instruments available to do so.

Derivatives are one of the first instruments for hedges that come to mind. Derivatives are financial products, such as futures contracts, and options, with a value that's largely based on the value of the underlying securities, commodities or other financial instrument.

For example, you can buy what's known as a "put." If the stock or portfolio index goes down in value, the put goes up. In this way, you create a bottom to what you may have lost by offsetting the price you've paid and you may even make a profit. It's a logical technique but, quite frankly, it is expensive.

Other ways to hedge your investments include the purchase of alternative investments that are not correlated to the markets and, therefore, are not affected by the same market movements. A classic investment is

precious metals. You can also consider real estate, either your home or other real estate, as part of your portfolio. Similarly, you can invest in a Real Estate Investment Trust (REIT) as a way to take some of the huge cyclical bumps out of how the market affects your portfolio.

Q. Is there anything positive about market volatility?

Volatility can be your friend. It can allow for some very good buys if you learn to use it. Unfortunately, volatility is also scary and can be the reason you make very bad investment decisions. Those investors who concentrate on day-to-day swings in the market have perhaps the hardest time being rational in their investment decisions. It's one reason that managed money is a good place for some investors, so that someone else is controlling decisions regarding individual securities, guided by a stated investment plan rather than emotion.

Tax-filing deadline pushed back again

Once again, taxpayers can count on extra time to file their returns and pay taxes owed. You have two extra days this year, until April 17, to complete and submit most 2006 returns.

The two-day reprieve comes about because April 15, the usual tax day, falls on a Sunday this year. The following day, April 16, is Emancipation Day, a legal holiday in the District of Columbia. The IRS has said holidays observed in the nation's capital have an impact nationwide.

Although you have extra time, don't delay speaking with your D.A. Davidson & Co. Financial

Consultant about any tax-related questions about your investments. Our professionals can help you most easily if you don't wait until the last minute.

The IRS said the April 17 deadline will apply to:

- *filing 2006 federal individual income tax returns,*
- *requests for an automatic six-month tax-filing extension,*
- *2006 balance due payments,*
- *and tax-year 2006 contributions to a Roth or traditional IRA.*

In 2008, U.S. taxpayers will again face the usual April 15 deadline.