
Risk Management in a Complex World

The investment world is a significantly more complicated place now than it was 10 years ago. Its sphere is increasingly global and offers a broader variety of choices for investors. When events such as the crisis in Egypt occur, investors need to revisit the concept of risk and make sure they thoroughly understand what they own.

■ KING's Risk Management Technique

At KING, we know what we own. We are active, bottom-up managers who strongly believe risk management should begin with knowing your companies well and closely monitoring any developments that could potentially impact the stock, including macro events, politics, industry-specific occurrences, competitors, and/or internal developments.

We own focused portfolios of 30 to 35 stocks. Therefore, we can efficiently monitor for any pertinent events that may influence a company's stock price. By limiting our weightings to no more than 5% at cost, our average holding is typically a 3.3% position. We actively trim positions approaching the 7% to 8% range in the portfolio. We usually have exposure to the majority of economic sectors, but more importantly, we strategically diversify within those sectors. Overweighting in an economic sector can occur relative to the benchmark, and this is usually the by-product of a few factors including low valuations and attractive cash flow characteristics.

A company's financial profile can be a key indicator to identifying potential risks for investors. Some of the greatest financial disasters over the past decade have been caused by overly leveraged balance sheets (i.e., Enron, WorldCom, AIG, Lehman Brothers, Bear Stearns, Citigroup, etc.). Therefore, it is imperative to scrutinize a company's balance sheet before committing to an investment. However, this is a difficult task to do when evaluating a company that does not follow GAAP accounting standards, such as foreign entities, or when investing in ETFs and mutual funds. Because we focus on companies with clean balance sheets and sustainable cash flows, our methodology allows us to identify and avoid companies that carry extended leverage. When the market enters into periods where capital and credit markets tighten, our stocks, overall, tend to hold up well.

A strict sell discipline is also a key component of any risk program. At KING, our sell discipline dictates that we sell a stock which meets the following criteria: (1) meets its price target; (2) more attractive alternatives exist; and/or (3) a change in fundamentals occurs. We closely monitor our stocks for any of these three criteria, especially a change in fundamentals.

It is not only about fundamentals, however. Another metric we use is tracking the daily performance of our stocks versus the market. We monitor how each stock is performing versus the S&P 500 and the Russell 3000[®] on a 10-, 30-, 50-, and 200-day moving average basis. This is not a true stop loss, but when a stock starts trailing by 5% or more, the Investment Advisory Group asks the questions: "What are we missing?" and "What, if any, actions need to be taken?" We implemented this enhancement to our sell discipline after the 2001-2003 bear market and it has been an effective tool as evidenced by significant outperformance during the 2008 downturn.

■ Sharpen the Risk Measurement Tools

In addition to having sound risk management policies in place, investors should be aware of the potential shortcomings of certain techniques that are commonly used to measure risk. We believe some of the more traditional risk measures have failed recently, or are no longer accurate.

One example is Value at Risk (VAR). Many Wall Street firms, including Bear Stearns and Lehman Brothers, used VAR as a risk measurement technique to monitor their portfolios of CDOs and CDSs. While VAR has

been an adequate risk barometer in the past, it possesses a fatal flaw when applying it to newer financial instruments where liquidity is not abundant. Since VAR is based on volatility, if there is only light trading in a market, the analysis is inherently skewed. If an extraneous shock occurs, volatility, which was never before registered, might suddenly occur. Unfortunately, you cannot measure risk until this occurs. Because the CDO and CDS markets were not overly liquid, VAR vastly underestimated the risk that was inherent in these portfolios, ultimately contributing to the collapse of both Lehman and Bear Stearns. As new innovations arise, VAR, and other traditional risk measurement ratios, are likely to be challenged in terms of accuracy.

International Investing and the Pitfalls of Non-Transparency

Most would agree, that risk is mitigated through global diversification. At the very least, there are more growth opportunities today than ever before, given the globalization of markets and economies. The challenge lies in accessing this return potential while minimizing risk along the way. At KING, we believe this is still achieved through company-specific fundamental analysis rather than through investment instruments such as ETFs.

While we endorse global diversification and capitalizing on these growth opportunities, it is important to (1) know what you own, and (2) properly weigh risk and returns. To this end, ETFs have become extremely popular over the last decade and have experienced explosive asset growth. While they provide an easy and cost effective way for an investor to diversify a portfolio, it is necessary to understand how they are comprised and what risks they present.

When evaluating a particular ETF for investment, it is important to consider the composition of the underlying index and the methodology used to assign weightings to individual holdings. Benchmarks that utilize market-cap weighting strategies have the potential to result in a heavy concentration of holdings in a handful of stocks—something that is less than desirable for those who value true diversification and elimination of any company-specific risk. Consider the following examples:

- MSCI EAFE Index (EFA) is composed of 89% European and Japanese stocks.
- iShares/FTSE China 25 Index Fund (FXI) allocates 46% of its assets to Chinese financials.
- MSCI Brazil Index Fund (EWZ) owns approximately 80 securities, however, two companies compose 20% of the total assets — Petrobras (10%) and Vale (10%). The top ten holdings account for 62% of the fund.
- S&P GSCI Commodity-Index Trust (GSG) has a two-thirds weighting in oil and gas with the remaining third in agriculture, industrial metals, livestock, and precious metals.
- Energy Select Sector SPDR (XLE) has 40 holdings. However, Exxon Mobil (19%) and Chevron (14%) make up one-third of the assets. XLE's top ten holdings represent 65% of its total assets.

Obviously, European nations and Japan are faced with significant debt problems and are implementing necessary austerity measures to correct these problems. This may not be the best risk/reward for an investor looking to add alpha to their portfolio.

Additionally, the Chinese economy has been very dynamic and is not overly dependent on any single industry to drive its impressive growth. If any form of credit issue emerges in this economy, an investor is highly exposed, rather than being diversified across multiple sectors. An alternative strategy to gain exposure to this economy is through companies that export a large amount of product to China, such as CONSOL Energy, Inc. (CNX)—a coal exporter—or a healthcare company, which focuses on diseases that are prevalent in the region.

Likewise, an investor could also capitalize on South American growth potential via Bunge Limited (BG), a highly geographically diversified company, which benefits greatly from sugar cane and ethanol demand in Brazil.

With certain ETFs it is not only the lack of diversification that may be a concern, but also a lack of performance. After the BP spill in the spring of 2010, the entire energy sector sold off significantly, creating an interesting buying opportunity for select companies. If you had purchased United States Oil (USO)—one

of the more popular oil ETFs, you would have made a 14.84% return from 6/30/10 through 12/31/10. If you had purchased Schlumberger Limited (SLB), your return over the same period would have been 51.9%, or HESS Corporation (HES) +52.5%, or Superior Energy Services, Inc. (SPN) +87.4%. We purchased all three of these stocks (in various portfolios) as each either benefited from the spill (by offering clean-up services of some sort) or had an international bent and less exposure to the Gulf.

Accessing Emerging Market Opportunities through U.S.-Based Companies

Emerging market GDPs around the world have been growing at a very rapid rate; Singapore recently reported GDP growth above 30% and China has been growing at very consistent pace. Many investors attribute the rapid growth in emerging markets to ongoing urbanization and growth of the middle class. As citizens of emerging markets leave agricultural jobs behind to find higher-paying employment in an urban setting, disposable income and quality of life improves; this translates into more spending and a surging consumer market. Ironically, while the consumer markets may be the growth driver of tomorrow, it is very difficult to find exposure via emerging markets today.

Below are some of the more common emerging market ETFs. Interestingly, none allocates more than 5% to the consumer sector, while they allocate considerable weightings to the energy and financial sectors.

ETF (as of 12/31/10)	Consumer Discretionary	Energy	Financials
iShares MSCI Emerging Markets Index (EEM)	4.6%	15.0%	25.1%
iShares FTSE China 25 Index (FXI)	1.4%	11.9%	46.9%
iShares MSCI Brazil Index (EWZ)	3.9%	25.2%	21.3%
iPath MSCI India Index ETN (INP)	4.6%	16.6%	24.1%
SPDR S&P Russia (RBL)	1.0%	43.2%	10.6%

Without question, an investor needs to capitalize on growth within these various regions. The question is how. We advise through investing in companies that have sound balance sheets and healthy international revenue exposure, yet are fully transparent. To gain access to the emerging market consumer, which should be a growth market for several decades, is to buy stocks of companies that sell to that consumer. Ironically, most of these companies are based either in the U.S. or Europe. Consider these:

- NII Holdings, Inc. (NIHD) is one of the fastest growing telecommunications companies in the world. It is based in the U.S. but does not derive a dime of profits from American soils. Instead, it operates an extensive wireless network in Latin America, where cell phone use is rapidly growing.
- Mead Johnson Nutrition Company's (MJN), a U.S. based infant formula company, derives 60% of its profits from emerging markets.

In both scenarios, an investor has direct access to the emerging market consumer and can capitalize on growth in that region, but from a risk measurement perspective, the investor knows what he owns, can better analyze the books and balance sheets, and is less exposed to the unknowns of an ETF or an investment lacking full financial transparency. From a return perspective, both of these stocks solidly outperformed the iShares MSCI Emerging Markets Index ETF in 2010 (NIHD and MJN returned 33.0% and 44.8%, respectively, versus 16.5% for the MSCI).

In conclusion, it is imperative to know exactly what you own, and to have a structured procedure in place to monitor activities that impact your positions. On first glance, the most obvious way to diversify and add alpha to a portfolio (i.e., via ETFs) is not always the best option. With so many choices available to investors, intensive research is necessary to make the right choices. At KING, our risk management techniques and policies have evolved over time (and through a wide variety of markets over the past 30 years). We believe that we have solid discipline in place, which will ultimately benefit our clients with outstanding long-term performance.

King Investment Advisors, Inc.