

# Diversified investing

How to weather a volatile market **Interviewed by Chelan David**

In recent months, the stock market has experienced unprecedented volatility. Many jittery investors, fearful of further declines, have fled to safer havens. While it can be tempting to convert stocks and bonds into cash during times of financial uncertainty, volatility creates opportunities to buy stocks that are significantly undervalued.

In order to cope with a volatile market, it is important to stick to your long-term investment strategy, manage risk through diversification and avoid making rash decisions.

“One needs to be patient in one’s decision-making,” says Alan Cole, president of Cedar Hill Associates. “Maintain your investment discipline and don’t deviate solely because the world doesn’t seem the same as it was a week or month ago. Investment decisions should be based on an assessment of fundamental information regarding how the investment climate will be in the future.”

*Smart Business* spoke with Cole about the reasons behind the market’s volatility, how risk can be managed through diversification and the importance of creating a customized investment strategy.

## What are some of the underlying reasons for the market’s recent volatility?

There are two primary causes: fear and deleveraging. Over the past year or so, the element of fear can be broken down into several different phases. Early on, there was a concern over the impact of the declining housing market on the stability of the financial system. In September, the failures of Lehman Brothers, Fannie Mae, Freddie Mac and AIG led to a genuine concern that the entire financial system was going to crumble because of the interconnectivity amongst the major banks. October witnessed governments worldwide stepping in to allay much of the concern over the financial system crumbling. More recently the market is sorting out the economic consequences of tight credit markets, rising unemployment and the worldwide economic environment. Everybody recognizes that we’re in a severe recession. The question is, how long will it last and how bad will it be?

The other reason for the volatility is the deleveraging going on in the system. This was



**Alan Cole**  
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initially selling by the banks to help fortify their balance sheets, followed by institutional selling — primarily at hedge funds — which caused a lot of the wide swings in the markets in November and December.

## What strategies should be deployed when investing in a volatile market?

Regardless of what stage of the economic cycle you are in — whether it’s a good time or bad — risk management remains an important continuous process. Part of it is being prepared through diversification. Entering a volatile market with the flexibility to take advantage of opportunities is a preferable position to just riding out the storm. It’s preferable both from an asset preservation as well as a psychological perspective. In a volatile market, many investors experience panic and fear and do not make sound decisions.

## How can one best strike a balance between risk and return?

We like to focus on risk — and how to best diversify risk — first and foremost, rather than just looking at the opportunity for return. Different investments have dif-

ferent risks. Diversifying investments to include both traditional and nontraditional asset classes can help lower overall risk as measured by volatility. Less risk doesn’t necessarily mean less return. If you properly diversify your risks, you can both achieve an attractive return and lower the portfolio risk at the same time.

## How can risk be managed through diversification?

Understanding what diversification really is and how to achieve diversification is the first major hurdle. Many firms believe diversification can be accomplished by investing in different sectors of the equity market, be it value managers versus growth managers, large companies versus small companies or domestic stocks versus international stocks. Our view is this approach isn’t really staying true to diversification because each of these strategies maintains a key common element: the risk that equity markets move in tandem and decline.

From our perspective, diversification has to include other investment strategies. Typically, people look at bonds as diversification from equities. But for much of 2008, corporate and municipal bonds declined at the same time equities were falling. Our approach is to diversify not only with bonds and stocks but also, when appropriate, to incorporate other nontraditional asset classes such as real estate, energy and private equity.

## What are the benefits of creating a customized investment strategy?

Some larger firms focus on allocation models that classify clients into certain generic categories such as appreciation-oriented or income-oriented. This approach might be very efficient for the investment firm when dealing with a large number of clients, but it is less likely to meet each client’s specific needs. A customized approach, however, better serves each client’s circumstances, as allocations can be crafted to address specific income, liquidity and tax scenarios. <<

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