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How to Limit Your Risks

Inattentive investors can wind up with lumpy and lopsided portfolios. Hedge funder Curtis Macnguyen knows six ways to get the balance back | By Michael Maiello

MONEY MANAGERS WILL trot out asset allocations galore for you. They'll plug in your age, income and risk tolerance to arrive at the "right" mix supposedly designed to build your wealth. But maybe you don't need all these formulas or the formulaic answers they give. Maybe all you need is a little commonsense advice in restoring balance to a lopsided portfolio. Curtis Macnguyen, an accomplished hedge fund manager, follows some simple rules that can help investors insulate their portfolios against misfortune.

Macnguyen, 38, started his fund, Ivory Flagship Strategy (assets: \$2.9 billion), in 1998. Since then, he says, it has returned a compound annual 14% after fees, versus 3% for the S&P 500. He says Ivory has lost only 2.6% in its worst month (September 2001), versus -14.6% for the broad market (August 1998).

You can't replicate his portfolio, which has up to 100 positions and a fair amount of turnover (between 100% and 150% in a typical year). But you can copycat his core philosophy, which is to avoid needless risk. Avoid risk, that is, that you don't get paid to take. And that risk often hides in plain sight.

Macnguyen, who works out of offices in Los Angeles and New York, used to be an analyst for a hedge fund run by Siegler, Coltery. During his apprenticeship there he noticed that the firm tended to short momentum-driven growth stocks while owning unpopular old-school issues. Though he won't discuss his old employer's trades, a typical scenario he saw at the time was for an investor to buy a traditional bookseller like Borders Group while shorting then-hot Amazon.com.

Taken individually, every position told a rational tale. "If you're right on the stock, you will make money on it over time," Macnguyen says. "But in the short term, say 12 to 24 months, you can lose your business."

In a new book, *Capital Ideas Evolving*, the noted Wall Street author Peter Bernstein describes the high art of risk management at Goldman Sachs, which has managed to trade for its account pretty successfully in fair times and foul. Goldman knows, Bernstein says, that your odds are better selecting the right individual securities than trying to time markets or make sector bets. But don't get so preoccupied with trees that you don't see the forest. Here are some strategic mistakes that people make.

OVERCONCENTRATION This goes beyond tilting toward a hot sector like tech. What Macnguyen fears is laid out in a 2007 working paper by Washington University finance

to justify their fees by finding obscure stocks, have also been chasing the sector.

Is the outperformance of small stocks axiomatic? Far from it. During the 1990s big companies did much better. Perhaps the next decade will be a repeat of the 1990s, not the 2001–07 period.

If you define as "small" a capitalization below \$2.5 billion and as "large" one that tops \$12 billion, then the U.S. market is 8% small, 72% large. If your portfolio has a small-company weighting well above that 8%, shrink it.

TOO MANY OR TOO FEW JUNKY COMPANIES In 2002 highly leveraged companies—defined here as those whose credit ratings are below investment grade, meaning junk bond level—got beaten down as default rates spiked to well above historical norms, according to Moody's. Default rates tend to peak right after recessions, and 2002 was no different (the

forming small-cap stocks are fallen angels, onetime large stocks that took a tumble and are now coming back.

These things move in cycles, however, usually lasting five to seven years. Growth got five years between 1995 and 2000. Now value has had seven years. It stands to reason that the ground will shift before too long. While Macnguyen is agnostic on how much to put in each, a heavy position on value now is likely unwise (see "Sell Your Value Stocks," FORBES, Apr. 9).

OWNING THINLY TRADED STOCKS Best to avoid them. Define this group as companies with market capitalizations below \$400 million or an average daily volume below 50,000 shares. There are indeed some undiscovered gems here, but there is also a lot of overhyped garbage. The Pink Sheets, a price listing for smaller stocks, has seen its volume balloon 1,560% from five years ago. Irrational exuberance.

Value and small caps are hot, so go light on them.

professor Hong Liu, "A New Explanation for Underdiversification."

Liu says that the median number of stocks held by an investor with a stock portfolio is only three. Three? That's up from two in 2000. Why this is so low has vexed academics for years. One reason may be inertia: You inherit two stocks from your grandmother, buy two more, then lose one in a merger. Liu suggests that a lot of investors view owning more stocks as adding rather than reducing portfolio risk. The right number of stocks to own is more like 20.

SMALL-CAP TILT Since 2001 small companies (as measured by market capitalization) have outperformed large ones. In the last six and a half years the S&P SmallCap 600 index has averaged a total return of 8.4% a year, compared with 3.1% for the large-company S&P 500. Investing, as they are wont to do, with a rearview mirror, people have crowded into small-company funds. Some celebrated portfolios have closed, notably Third Avenue Small-Cap Value, Royce Premier and William Blair Small Cap Growth. So the money rushes into other funds with lesser pedigrees. Meanwhile, hedge fund managers, seeking

last recession started in March 2001 and ended that November). In 2002, 19% of junk bond issuers defaulted, and Moody's considered another 21% of them to be "distressed," meaning they had a just-above-default credit rating of C.

A year later conditions improved. Though the junk default rate inched down only to 18%, Moody's considered just 4.7% of high-yield issuers to be distressed. In 2003, says Macnguyen, the market rallied and indebted companies' stocks were taken for the ride, even outperforming companies in better financial condition.

You don't know about recessions in advance, so it's hard to time your entrance and exit from the junk universe. Instead, keep your presence there at a reasonable level. You can find free bond ratings by Fitch at www.fitchratings.com.

VALUE BIAS Since 2000, the end of growth stocks' reign (and the start of a two-and-a-half-year bear market), value stocks have outpaced growth stocks. The average value fund has a 10.5% annual return, compared with 2% for growth, says research outfit Lipper. This is somewhat related to the small-cap/large-cap issue: Many outper-

GOING SHORT Short interest on the New York Stock Exchange stands at 11.8 billion shares, up from 8.6 billion a year ago, according to Shortsqueeze.com. Why? The plethora of hedge funds. "Thousands of new hedge funds out there have no experience shorting," says Macnguyen. "So they just shorted what everyone else was shorting." A lot of those funds were clobbered when the market rocketed in 2003. A good number of individual investors try to latch on to this trend, to their ultimate sorrow.

One of the risks of a heavily shorted stock is the short squeeze. Bulls on a stock ask their brokers to remove their shares from the pool available for lending. The short-sellers who can't borrow elsewhere are forced to liquidate their positions by buying shares. That buying drives the price higher and puts the remaining short-sellers in more of a bind.

There's a temptation to dive into short-selling because that's what the pros do with their hedge funds. If you must play the bear game, look for a safer alternative. Buy either put options or else one of those new bearish exchange-traded funds from ProShares. **F**

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