THE RUDD COMMENTARY

{ JULY 2011 }

We are excited to publish this edition of *The Rudd Commentary*, which is a periodic publication designed to bring you a professional opinion on the current investment environment and some developing trends. Please feel free to forward *The Rudd Commentary* to family, friends, and business associates who might find this information valuable.

THE VALUE OF RISK

The second quarter of 2011 has been a volatile one, so I thought I would take some time to comment on a favorite topic of mine, risk. Although stocks staged a well respected rally as June came to a close, the second quarter was rocked by the usual suspects of high unemployment, a weak housing market, and sovereign debt worries. While there are many variables involved in the economic equation, these issues are center stage not just because they are important, but because they appeal to our common sense. As I look at the current investment environment, risk management is again taking center stage. This quarter, I would like to discuss the role risk plays in successful investing and how the public's view of risk is quickly changing.

THE GOAL »

As investors, why would we want to take on any risk? Can't we just buy certificates of deposit or an indexed annuity and eliminate all the risk? While personal bankers and insurance salesmen may pitch otherwise, the answer is no. With the recent media reports regarding concerns over the U.S. Treasury's credit rating, investors are beginning to wake up to this reality. There are many types of risks associated with every investment we make and they cannot be eliminated entirely. Therefore, one of the primary objectives of investors should be to fully understand the risks associated with their investments. This may seem like a very obvious and simple task, but I have found in practice that many investors lack a basic understanding of what they own. If investors can take the small step to fully understand the legal claims they own (their investments) and their ability to sell those claims to another party quickly at competitive prices, their efforts can be focused on minimizing material, unnecessary risks and ignore risks that are not likely to affect their ability to reach their long-term goals.

> "Risk should not scare us any more that it did some rebel English settlers 235 years ago. Risk means opportunity, opportunity means freedom, and while sometimes we don't like the outcome, freedom is better for all."

So how do investors manage risk in an efficient way, so their efforts are not wasted worrying about risks that are immaterial or out of their control? Most investment professionals manage risk by focusing on statistical measures such as standard deviation or beta. While these measures are important, in our practice we begin with the goal of each client to establish constraints, identify the primary risks to our goal, and then present a strategy to minimize these risks in order of importance. For example, many retired investors will initially tell us that they want complete principle protection of their hard earned wealth, but after a more in depth discussion (and a look at CD rates) they will discover that their long-term goal is actually to protect their standard of living in retirement and not be a burden on their children. The first "knee jerk" objective focuses more on credit quality and default risk while the revised goals highlight concerns involving income stability and inflation, which require very different strategies.

Understanding the investment environment and forming achievable goals are the steps to forming an appropriate long-term strategy. This process can help create an environment where investors can use risk efficiently to maximize their investment returns

instead of constantly reacting to their emotions and bad government policy. Risk should not scare us any more that it did some rebel English settlers 235 years ago. Risk means opportunity, opportunity means freedom, and while sometimes we don't like the outcome, freedom is better for all.

THE BUTTERMAKER PARADOX »

A few months ago, I volunteered to coach my son's little league baseball team. I didn't realize that this was going to be more of an education for me than the boys. I can honestly say that third only to building a successful marriage and starting my own business, coaching twelve six to eight year olds is one of the most challenging and fulfilling things I have ever done. Coaching requires commitment, stamina, and a personal interest in every individual on the team, not to mention the skills of a diplomat when dealing with the most interested stakeholders (parents).

As with most worthy activities, coaching youth baseball involves the choice to take risks. The short-term risks for the investment of my time and effort are very tangible and easy to calculate monetarily, but the choice to truly develop the skills and character of these young boys is hidden beneath the surface of the short Saturday games. In baseball, the long throw from third to first is a tough skill to master for a six or seven year old. I have found that some coaches will either encourage or discourage each boy to make this play (hold the ball and play it safe, avoiding an overthrow) based on each boys recent and expected short-term performance, ignoring the value of teaching boys when to take risks and the priceless lessons that can only be learned though failures. Instead of investing in every boy's long-term success, some coaches will instead offer very noble objectives that play on parent's short-term competitive desire to win today's game or save their children the pain and suffering associated with a loss.

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This very myopic view of risk has incrementally crept into our western society and become more common place. As parents we wrap our children in plastic from head to toe before they can get on a bicycle in a cul-de-sac. As baseball coaches we discourage our seven year olds from taking chances trying the hard plays or refuse to rotate less developed players into the key positions. And after deep market declines, as investors, we throw large amounts of our hard earned money into expensive insurance products in order to purchase a predictable stream of income at historically low interest rates. All these decisions seem very sensible in the short-term, but are truly futile attempts to remove 100% of the associated risks. These actions silently erode our core principles by removing the freedom to choose to ride better, learn the hard plays, and earn a reasonable return on our investment. The freedom to choose, "to risk", for ourselves and our children can greatly improve the opportunities for our future and are far more valuable than expensive entitlements that provide a fleeting, short-term success.

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