



When Things Go Wrong

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Last week as we began to see just what impact the faltering housing and credit markets could have on the broader financial system, our thoughts turned again to risk management. There are many professional money managers who boast of the measures to which they go in their efforts to monitor and control portfolio risk. They construct sophisticated mathematical models that test for weaknesses in their strategies, thereby helping them to achieve a better understanding of how a market crisis might impact their returns. This practice is almost universal, and yet far too often we see managers who have, under pressure from unforeseen events, sustained "theoretically impossible" losses.

The reason is a phenomenon known as a Black Swan, also called Tail Risk in Hedge Fund jargon. A Black Swan in nature is a rare and mysterious occurrence that defies explanation by conventional logic. A Black Swan in finance is a combination of negative events for which no precedent exists, often characterized in aftermath as everything, all at once, going severely wrong. While they generally tend to hit only a few market participants directly, their effects can be wide ranging and ripple through an entire financial system bringing misfortune and even ruin to many.

The current fear is that the effects of rapidly deteriorating capital positions in low quality credit markets will spread from Wall St. to Main St. and deal the final blow to an over-stretched consumer. This caused equities to sell off fiercely last week, and although it was more of a "Baby Swan" than a Black Swan event, there were some visible similarities. In a Black Swan, or any other major market crisis, 3 things tend to happen to investments in the traditional asset classes: correlations increase, volatility increases, and as these both happen, liquidity dries up.

To illustrate this, we examined the relationships between the TSX Composite, the Scotia Capital Short Term Bond Index, the CAD/USD exchange rate, the spot price of Gold, and the Dow Jones Commodity Index. We compared "normal" levels of correlation and volatility among these asset classes over the past year to those levels observed from Tuesday through Thursday last week. The results below show just how closely the fortunes of even safe-haven investments like gold or bonds are tied to the performance of equity markets during stressful times.

Annualized Standard Deviation

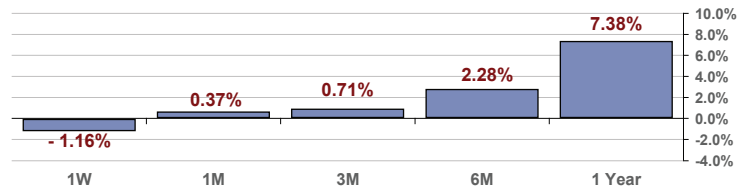
	Equities	Bonds	\$/C/\$US	Gold	DJCI
Normal	12.30%	3.03%	4.99%	16.47%	15.78%
Last Week	21.72%	7.94%	12.45%	18.02%	14.45%

Correlation with Canadian Equities

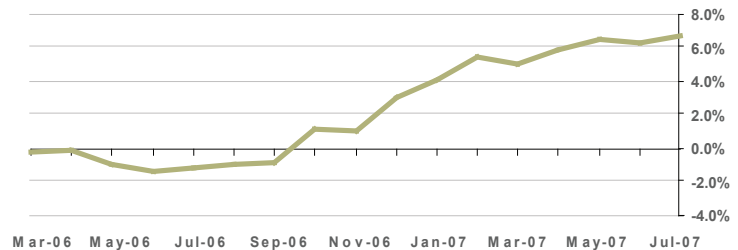
	Bonds	\$/C/\$US	Gold	DJCI
Normal	0.07	0.13	0.23	0.09
Last Week	0.35	0.57	0.54	0.81

PERFORMANCE

Periodic Investor Returns



Performance Since Inception



It's remarkable how relative volatility increases the most in those investments thought to be the least "risky". The high level of correlation between the TSX and the DJ Commodities Index during the most severe part of the sell off lead us to believe that in times of crisis, equities trade more like commodities, not the other way around.

Is risk management a science or an art? A workable answer seems to lie in each individual's attitude to defining what risk is. For some professionals, risk is a number to be quantified, scrutinized, modeled, and back-tested. Others, like those of us here at Barlow Capital, prefer instead to view risk as the inability to know what can (or will) happen in the future. We believe that this is a more helpful way to think of risk and one that allows us to make better decisions in the face of uncertainty. It reminds us that unknown dangers line the path forward and at the same time constructively addresses the task at hand.

Utilizing this approach we have successfully managed one of the top performing balanced mandates in Canada over the past 5 years while taking significantly lower levels of risk than the market. We take great pains to ensure that our clients' capital is protected in down markets. And as the research clearly shows, True Balance comes from diversification away from traditional asset classes, not within them.



TrueBalance™