PARITAS CAPITAL MANAGEMENT

A Closer Examination of Controlling Investment Risk

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Introduction

Investment strategies today come with risks, many of which, are unavoidable. This whitepaper will walk through some of the more common risks to a strategy and how we work to keep them under control to lessen their potential impact to a portfolio.

Our team has conducted years of research devoted to deeply understanding the risks to which a typical investment strategy is exposed and - more importantly - how new enhancements in both computing power and investment product can be used to mitigate these risks.

At Paritas, we have designed our investment process around managing as many layers of risk as possible in an effort to build more consistent investment strategies that help advisors and their clients meet their objectives.

Forecasting Risk

Many asset allocation strategies and models are heavily dependent upon forecasted returns and risk of an asset. In principal, it seems that forecasts would be a positive element that would consider future developments in the financial markets.

However, in practice, many struggle to correctly predict what will happen in the future. The graphic below displays analysis of S&P 500 price targets from 2000-2016. As we have outlined in our **previous whitepaper** on market forecasts, the results were quite astonishing, but not surprising.

Wall Street Strategist's S&P 500 Price Targets — **Miss**

	Year-End Forecast	Year-End Actual	Forecasted Return %	Actual Return %	Difference
2000	1,525	1,320	3.8	-10.1	13.9
2001	1,593	1,148	20.7	-13.0	33.7
2002	1,291	880	12.4	-23.4	35.8
2003	1,004	1,112	14.1	26.4	-12.3
2004	1,169	1,212	5.1	9.0	-3.9
2005	1,246	1,248	2.8	3.0	-0.2
2006	1,348	1,418	8.0	13.6	-5.6
2007	1,550	1,468	9.3	3.5	5.8
2008	1,632	903	11.1	-38.5	49.6
2009	1,078	1,115	19.3	23.5	-4.1
2010	1,225	1,258	9.9	12.8	-2.9
2011	1,371	1,258	9.0	0.0	9.0
2012	1,344	1,426	6.9	13.4	-6.5
2013	1,534	1,848	7.6	29.6	-22.0
2014	1,955	2,059	5.8	11.4	-5.6
2015	2,233	2,044	8.5	-0.7	9.2
2016	2,216	2,262	5.5	9.5	-4.0
2017	2,362	?	4.4	?	?
				Average:	13.2

Data as of December 31, 2016
Source: Bespoke Investment Group

The average miss (distance from Forecast to Actual) was 13.2%. If these forecasts were used to formulate a long-term asset allocation, the allocation could have been very inaccurate and exposed the investor to risks they may have not known they were taking. This could have led to underperformance in both up and down markets.

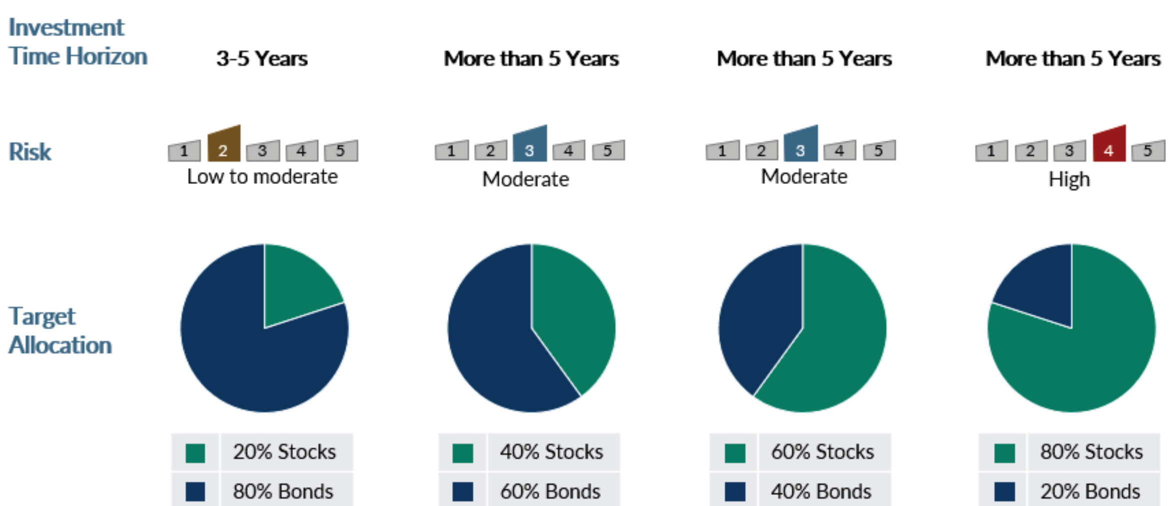
We subscribe to the belief that markets are unpredictable. There are too many variables to get right, especially when there are multiple asset classes involved. Exacerbating the issue is the timing of when the largest misses occurred – down markets. In our opinion, these are the most important years to be accurate. Additionally, over this 17-year period, the experts have never forecasted a down year.

To counteract the risks of forecasting, we have implemented a process that has a quantitative, risk-based foundation. It is based upon actual historical data points, both near and longer term, and aims to produce more consistent allocations and ultimately returns. There is no subjective overlay which we believe helps us obtain a more accurate representation of the current risk levels in the markets and translate that into an appropriate asset allocation.

Static Allocation Risk

Basing allocation decisions upon disparate factors unrelated to the current market environment can lead to asset allocations that may expose a portfolio to either too much or not enough risk. For example, many advisors stress "investment time horizon" as a basis for a static portfolio allocation *without* evaluating current market conditions.

The various portfolios below are constructed with a stated risk tolerance for an investor established by the completion of a Risk Tolerance Questionnaire (RTQ) from an industry leading mutual fund company.



Source: Vanguard.

If an account inception date occurs during a period of market stress and an investor has a longer time horizon, the portfolio would have a Moderate+ risk rating and could experience significant losses based upon the corresponding static allocations. These large drawdowns can take years to recover. Inversely, the portfolio could fail to capitalize on a high growth environment by maintaining a lower allocation to growth assets. Additionally, over time, the portfolio pays no attention to changes in market risk and adopts a "ride out the storm" mentality.

At Paritas, we look at asset allocation differently to eliminate static allocation risk. We believe it is important to follow a disciplined process to dynamically rebalance portfolios based upon changes in market risk. Having a rules-based process removes emotion from investment decision making and allows effective rebalancing to occur under the most extreme circumstances.

To fully benefit from this process, we believe there should be no artificial capital constraints placed upon the portfolio. By allowing risk to fully dictate the current asset allocation, portfolios can both protect and participate when appropriate.

Style Drift Risk

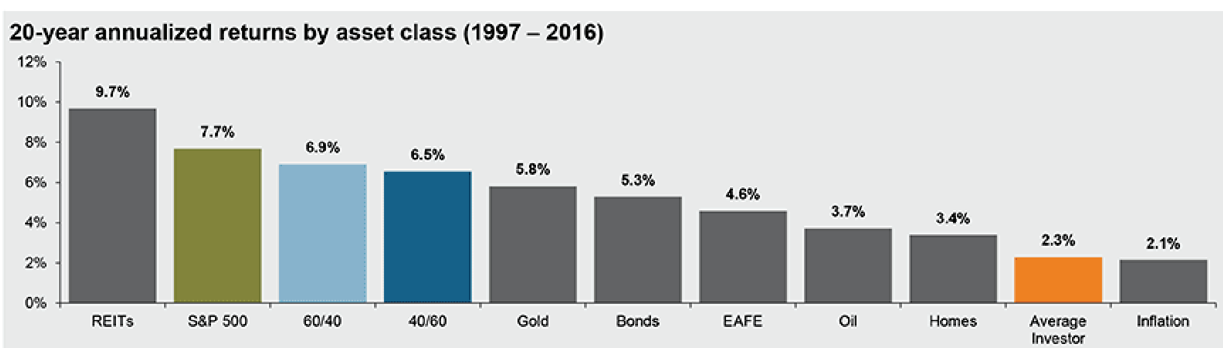
Investment managers can buy investments that are outside of their mandate which may cause portfolios to have an over or under exposure to a subset of investments. If a theme is doing well and an investor assumes they have the appropriate exposure but the manager they've selected has drifted from their mandate, they would actually be underexposed and not benefit. Inversely, the same holds true. These drifts, or deviations from investment mandate, may even lead to other risks, such as concentration risk -- another key risk we discuss later.

When managing a portfolio, we elect to use "plain vanilla" index ETFs to eliminate the potential for investment managers deviating from their mandates. Our research is centered around creating investment solutions that are more consistent and reliable. The potential for drift having a negative impact on a portfolio is a risk we were not willing to accept.

Investor Risk

It is not uncommon to find an investor who's expressed risk tolerance can abruptly change when markets are rising versus when they are falling. Allowing emotion to creep into the decision-making process has proven to cripple investors over the long term and led them to enter and exit the market at the wrong times.

In JP Morgan's *Guide to the Markets* presentation, they highlight investor returns over a 20-year period as compared to individual indices and static blended portfolios.



Source: J.P. Morgan Asset Management; (Top) Barclays, FactSet, Standard & Poor's; (Bottom) Dalbar Inc.
Indexes used are as follows: REITS: NAREIT Equity REIT Index, EAFE: MSCI EAFE, Oil: WTI Index, Bonds: Barclays U.S. Aggregate Index, Homes: median sale price of existing single-family homes, Gold: USD/troy oz., Inflation: CPI. 60/40: A balanced portfolio with 60% invested in S&P 500 Index and 40% invested in high quality U.S. fixed income, represented by the Barclays U.S. Aggregate Index. The portfolio is rebalanced annually. Average asset allocation investor return is based on an analysis by Dalbar Inc., which utilizes the net of aggregate mutual fund sales, redemptions and exchanges each month as a measure of investor behavior. Returns are annualized (and total return where applicable) and represent the 20-year period ending 12/31/16 to match Dalbar's most recent analysis.
Guide to the Markets – U.S. Data are as of January 31, 2018.

J.P.Morgan
Asset Management

While markets are experiencing a major decline, investors allow their emotions to take over and they tend to capitulate at, or near, the bottom. Compounding the issue, after experiencing the major loss, they are hesitant to get back in and miss any subsequent large moves up.

To curb investor risk, we focus on designing investment solutions that use risk to reduce the magnitude of drawdowns. We have an unconstrainted, disciplined rebalancing process that will allocate assets to more protection focused assets when applicable.

Having a process in place that aims to avoid these potential large losses, allows investors to feel more comfortable and remain invested through multiple market cycles. This helps them to capture a greater percentage of the market returns over the long term and meet their overall investment objectives.

Security Selection Risk

There are many decisions that need to be made to have a successful investment outcome. Security selection is one of them. Even if an investor gets the asset allocation correct and properly evaluates the risk of a given sector (or asset segment), they could still potentially lose money if a company specific event occurs in one of the securities they have selected. Over time, there is a demonstrated inability to consistently pick securities that outperform an index. One or two positions could significantly impact the performance of the entire portfolio.

We incorporate broad based diversification in our portfolio construction processes in an effort to remove idiosyncratic risk from the portfolio management equation. By leveraging the most liquid, large, index-based ETFs, we can minimize the impact of a single security on a portfolio.

We can further break down these major indices into their component parts (i.e. sector, segment, or geographical level) to further minimize risk. This helps us construct portfolios that are aimed at providing consistent risk-adjusted returns over the long term and a smoother ride for investors.

Concentration Risk

Often, whether known or unknown, portfolios contain a significant allocation to a particular security, asset segment, asset class, or country. There are many different ways overconcentration can occur; it could be purchasing multiple mutual funds that have similar top positions, buying larger indices that favor certain sectors or countries, or even investment manager style drift. When they do occur, the results are typically not positive and have an outsized impact on the portfolio's return during both up and down markets.

Additionally, a high concentration of asset can give a false sense of diversification and mask large amounts of positive correlation. Everything in a portfolio going up (or down) at the same time is not necessarily a good thing when it comes to portfolio construction and diversification.

We work to eliminate concentration risk when constructing portfolios. We examine holdings for purpose and exposure. Simply put, this means we are looking to see what positions are included in a particular index to obtain a minimal amount of overlap. We also attempt to include assets with lower overall correlation which allows for the potential of increased risk-adjusted returns through various market cycles.

Conclusion

We have worked to manage the common investment risks discussed above and created an investment process that can provide investors with a smoother experience over the long-term. Our focus on quantitative, risk-based investment solutions can help investors achieve their overall investment goals by providing consistent risk-adjusted returns with lower volatility.

We aim to build portfolios that align with investor expectations while focusing on eliminating surprises that would trigger an emotional response.

A well thought out investment process does not leave your clients' asset allocation to chance. Paritas' disciplined, rules-based approach can help you protect and grow the wealth your clients worked hard to earn. We believe that an investment process without rules is not a process and is a recipe for disaster.

Important Disclosures

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