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LATEST ARTICLES

Is Risk A Four Letter Word?

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Chief Investment Officer

"There are risks and costs to action. But they are far less than the long range risks of comfortable inaction" – John F. Kennedy

In light of recent market volatility, risk might have you feeling like it's a four letter word lately. Are all four letter words necessarily bad, however? They certainly can be but that would depend on both your perspective and their application (after a bad golf swing comes to mind)! As a four letter word, risk, and in particular investment related risk, has both negative and positive connotations but depends, again, on both your perspective and application.

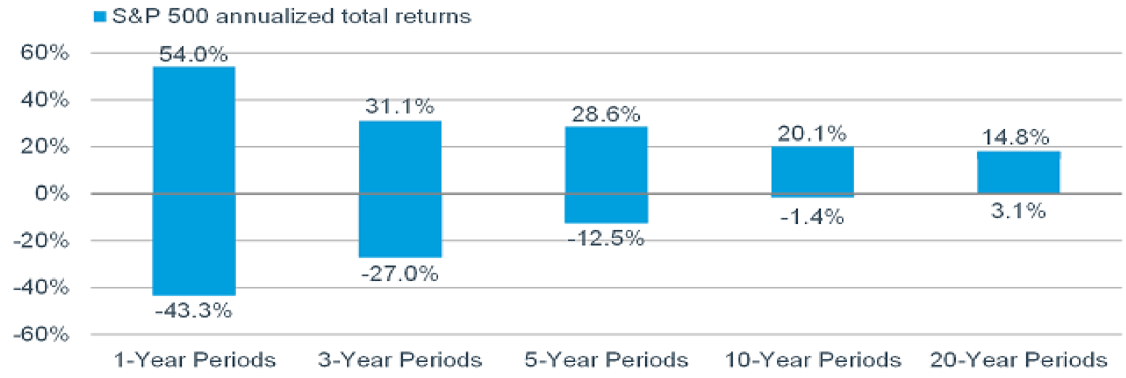
As children we were all told to not touch the stove or to be careful around stairs and so risk aversion gets instilled in us from a very early age. But without fire you can't cook and eventually in order to get where you need to go you are going to have to learn how to deal with stairs. As adults we know that there is risk of injury in exercising but we do so anyway for the potential reward of living a longer and healthier life. Risk and the resulting reward of a wonderful meal, a beautiful view or an active lifestyle are part of our everyday lives and generally speaking, we manage these types of risks with far fewer emotions than we do the risks associated with our investments. A lot of that could have to do with our understanding of investment related risk and our emotional sensitivity about money because of what it can do for our families and the lives we want to personally live. But if we embrace prudent risk taking as a path to life's rewards, a means to an end if you will, then perhaps the way we think about risk and react to it can begin to change.

For most investors, investment risk is associated with the overall volatility of their portfolio and the chance that when they need the capital it will be worth less than is required. Volatility, however, can be managed through a sound asset allocation plan which involves allocating capital to asset classes of varying risk levels and return profiles in such a way that an overall level of return/volatility is achieved given your individual goals, time horizons, objectives etc. If you get the asset allocation right and then maintain an investment perspective consistent with your time horizon, there shouldn't be too many sleepless nights, even during the inevitable pockets of market turbulence.

Part of the confidence in this approach lies in the fact that while markets will correct from time to time; they can and do historically recover. In fact, according to JP Morgan's July 2015 edition of "Guide to the Markets", the average intra-year correction in the S&P 500 over the past 35 years has been 14.2% (median 10%) and yet the market ended up closing in positive territory in 27 out of those 35 years.

Furthermore, according to Wealthfront, market declines between 10-20% take 107 days on average to recover their lost ground. Of course steeper declines take longer to recover but they too have historically recovered as innovation, earnings, valuation and global growth eventually take over. Lastly, unlike actual gambling where the longer you sit at the casino the greater the odds are that you'll lose, with investing, it's the opposite as the below chart from the Schwab Center for Financial Research illustrates.

Therefore, with the proper asset allocation, quality holdings and a long term view there is less to fear in the long-term risk of the market.



Source: Schwab Center for Financial Research with data provided by Standard and Poor's. Every 1-, 3-, 5-, 10-, and 20-year rolling calendar period for the S&P 500 Index was analyzed from 1926 through 2014. The highest and lowest annual total returns for the specified rolling time periods were chosen to depict the volatility of the market. Returns include reinvestment of dividends. Indexes are unmanaged, do not incur fees or expenses, and cannot be invested in directly. Past performance is no indication of future results.

In closing, it could be helpful in times like these to think of the risk of specific asset classes and holdings within your investment portfolio not as potential adversaries ready to attack your well-being at any time, but view them rather as a collection of diversified return streams that over time are like different channels of a river, working their way in and around various obstacles eventually filling up a lake, your financial lake, somewhere down the line. Warren Buffett and other noted long-term focused investors have said that if we focus on *what* we own - a collection of diverse, high quality assets representing a varied set of return streams, (our words), the "*when*" will largely take care of itself given enough *time* and that is the kind of four letter word that will help you sleep better at night.

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MicroCap Value: A Good Alternative to Private Equity?

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Private Equity refers to investment partnerships that invest in the debt and equity of private companies. Private Equity generally comes in two forms (1) Buyout Funds, where mature companies are purchased using debt, and (2) Venture Capital Funds, where small companies with large growth potential are purchased. The intent of the Private Equity fund is to eventually sell their investment, either to another fund, company or through initial public offering for a gain.

For investors with substantial capital to invest, Private Equity funds have become a very popular choice. And why shouldn't they be? After all, Private Equity funds have offered better performance than the S&P 500 with less volatility and low correlation. This certainly sounds like a winning recipe. Indeed, in many cases investing in Private Equity can be a productive choice, but Private Equity is not a standardized product easily picked off the shelf like a gallon of milk. Manager selection is absolutely critical, even more so than for mutual fund managers. Thankfully, there is another option, an *alternative* to an alternative if you will…MicroCap stocks!

MicroCaps, which Ancora defines as equities having market capitalizations of between $25 million and $500 million, are often overlooked by investors despite their attractive qualities. We outlined those reasons in our whitepaper titled "MicroCap Myths". In this new white paper we expand on "MicroCap Myths" and explain why MicroCap might be a good alternative/compliment to Private Equity as a portion of one's Private Equity portfolio allocation.

[1]MicroCap Value Returns

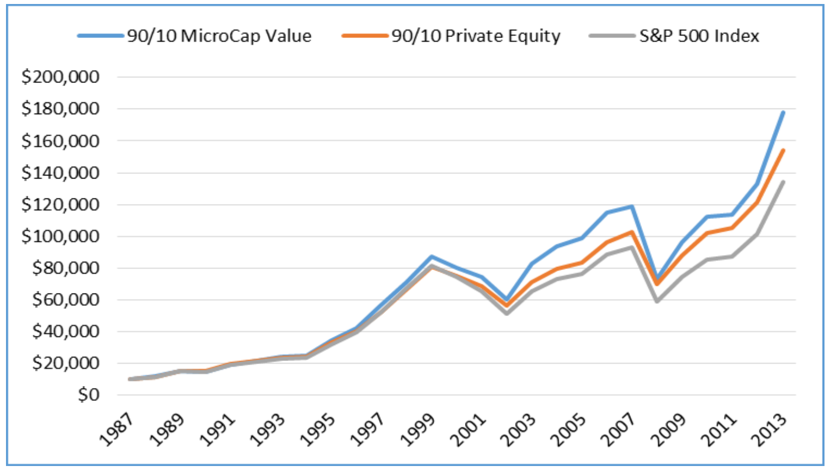
As we explain in our "MicroCap Myths" paper, all MicroCaps are not created equal. MicroCap Value, the two smallest deciles by market capitalization and price-to-book value, has outperformed the market by a significant amount over the past 50 years.

In fact, MicroCap Value returns exceed Private Equity by 5% per annum on a standalone basis. Figure 1 shows in chart form what a hypothetical 25 year period of performance would have returned for the following portfolios:

1. A portfolio consisting of 90% S&P 500 and 10% MicroCap Value, labeled as "90/10 MicroCap Value"
2. A portfolio consisting of 90% S&P 500 and 10% Private Equity, labeled as "90/10 Private Equity"
3. Finally a portfolio of 100% S&P 500 Index

As demonstrated in Figure 1, the "90/10 MicroCap Value" portfolio performs admirably, increasing returns without adding unnecessary risk as the MicroCap Value enhanced portfolio exhibited only slightly higher volatility over the time period. This is a direct result of lower correlations with the S&P 500. The following are some of the salient comparison points when comparing MicroCap Value with Private Equity.

Figure 1



Diversification

Correlation describes the movement of assets together, with a correlation of 1 representing perfect movement, 0 describing no relationship in movement -1 describing a perfectly opposite movement. MicroCap Value has a correlation of 0.60 with the S&P 500 and Private Equity has a correlation of -0.17. It is due to this lower correlation that MicroCap Value is able to increase the return to the "90/10 MicroCap Value" portfolio without adding risk. While Private Equity correlation is lower than MicroCap Value, this may be the outcome of illiquidity and a lack of market quotations than true low correlation.

Liquidity

Unlike mutual funds or ETF's, Private Equity funds are not traded on an exchange and are not quoted daily. In fact Private Equity funds are known for requiring long lock-up periods for their investors, often for 7 to 10 years. This lack of access to capital is known as liquidity risk, with Private Equity having high liquidity risk because it has very low liquidity. In many cases, the lock-up period is not a problem and investors in Private Equity potentially have the means to defer accessing their capital, but unexpected events can change that.

Another potential disadvantage of Private Equity due to lack of liquidity is the inability to replace poorly performing managers due to the lock-up feature. The difference between top and bottom Private Equity managers can be very large. The consequence of being in an underperforming Private Equity fund is that capital is likely stuck in it for the long haul.

Leverage

A byproduct of investing in Private Equity, particularly for buyout funds, is the use of leverage. This can result in unintended sources of risk in a portfolio. The Wall Street Journal reported that 40% of US Private Equity deals in 2014 used leverage above ratios the Federal Reserve and the Office of the Comptroller of the Currency consider safe. Not only does this introduce additional interest rate risk, but it also brings additional credit risk. For instance, if interest rates rise and a company has too much leverage, they may not be able to afford the interest payments at the higher rates if their debt is variable or if they need to refinance. Leverage is easy to avoid and diversify away with MicroCap Value.

Size of Companies

Most Private Equity deals are made in the small cap arena with many done in even smaller MicroCap sized companies. Utilizing public MicroCap stocks exposes a portfolio to many of the same benefits of small cap inefficiency which Private Equity funds seeks to exploit. This inefficiency is known as the "Small Cap Premium", which may be more pronounced in MicroCap stocks which frequently have an even lower average market capitalization than Private Equity.

In conclusion, the popularity of Private Equity is partly attributable to the club like access to the asset class and partly to the exceptional returns of the upper quartile managers. However, as discussed, Private Equity is not a standardized group and accessing those excellent managers can be difficult. Few stop to ask if there are alternatives or compliments to Private Equity which do not have the associated liquidity risks. MicroCap Value, in addition to yielding greater returns, also offers significant diversification benefits and most importantly, gives the investor precious access to liquidity.

[1] Private Equity returns source: Cambridge Associates, "US Private Equity Index and Selected Benchmark Statistics". December 31, 2014. US Private Equity: Since Inception IRR & Multiples by Vintage Year. Net to Limited Partners. Page 8. http://40926u2govf9kuqen1ndit018su.wpengine.netdna-cdn.com/wp-content/uploads/2015/05/Public-USPE-Benchmark-2014-Q4.pdf

MicroCap returns Source: French, Kenneth, 100 Portfolios Formed on Size and Book-to-market (10x10). The returns used are an average of the smallest two deciles by market capitalization and price-to-book value. Ancora has deducted an annual fee of 1.26% for comparison purposes. We used an average of the fees of ten MicroCap mutual funds with at least $100 million of asset under management. http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html#BookEquity

S&P 500 source: http://us.spindices.com/indices/equity/sp-500

The Wall Street Journal, "Debt Rises in Leveraged Buyouts Despite Warnings" May 20, 2014. http://www.wsj.com/articles/SB10001424052702304422704579574184101045614

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401(k) Plan Reviews on the Rise

Peter Mooney

President, Source Companies, LLC

According to Cogent Wealth Reports, 75% of 401(k) plan sponsors intend to initiate some sort of formal review of plan design and their service providers over the next twelve months. In this interview, we sit down with Peter Mooney, President of Source Companies, Inc., a subsidiary of Ancora Advisors, LLC., for an update on the current 401(k) landscape. Source Companies, Inc. specializes in plan services for retirement.

Q. Peter, in your view, what are the two or three major issues facing 401(k) plan sponsors over the next twelve months?

A. I believe that the main issues facing 401(k) plan sponsors are costs, employee education, trustee fiduciary liability and in general determining what the best overall solution is for their particular company and employees given the uniqueness of their business. It is not a one size fits all approach.

Q. What is driving the current increased plan review cycle?

A. I believe that the main reason for the increase in plan review is the increased concern from plan sponsors about fiduciary liability. Solutions in the 401(k) space are changing to provide more information on fees and the true cost to the plan. Fees are under a microscope and plan sponsors need to have their current plans reviewed to ensure that they are providing the most efficient solution for their employees to save money for retirement.

Q. Please describe what the biggest trends in 401(k) plan design are and how the tax laws have impacted plan design.

A. The two biggest trends in 401(k) plan design are automatic enrollment and automatic contribution increases. Both features allow for stronger participation and help employees grow their retirement balances. Utilization of current tax laws plays a key role in plan design. Two opportunities often overlooked are new comparability and cash balance plans.

Q. Describe what an open architecture plan means.

A. Open architecture means there are specialized providers for the different services that make up a retirement plan platform. Many companies offer their employees a bundled 401(k) product from a mutual fund or insurance company, but that particular company may not be the best fit across all of the service elements of the plan. As a result, if the organization is unhappy with any component of its plan, it is forced to physically move the plan's entire asset base and start over with another mutual fund or insurance company because unfortunately it is difficult to break apart the offerings in a bundled plan.

Open architecture plans, on the other hand, allow employers to change any of the silos of the plan — the registered investment adviser, the third-party administrator, the record keeper — without having to move the plan assets. Therefore, you can change any of the components of the plan without having to move everything and start over if some element needs to be changed. We believe that open architecture leads to more fee transparency, a higher level of expertise and a better long-term client/participant experience.

Q. What are the components of a well-structured participant education program and how does that assist participants, especially in volatile markets?

A. No two 401(k) plans are exactly alike so it's impossible to say that there's one best formula for success in designing a 401(k) education program. However, every educational program should include multiple ways to "touch" or communicate with plan participants and encourage retirement readiness. Electronic communications including weekly market updates, monthly newsletters, financial calculators and other on-line planning tools and perhaps most-importantly, opportunities for participants to meet for regularly scheduled in-person check-ups with trained professionals from the plan's investment advisory firm are all part of a well-designed participant education program.

If you are a 401(k) plan sponsor and have an interest in a complimentary review of your current 401(k) plan, please contact Peter Mooney at 216-593-5095 or peter@sourcecos.net

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