LONGBOW ASSET MANAGEMENT COMPANY
Quarterly Investment Note
July 26, 2004

Undeniably, and as the recent weeks have reiterated, financial markets contain uncertainty, which is simply a synonym for risk. While risk exposure is unavoidable, risk management, the portfolio manger's responsibility, is very achievable. Wise investors, rather than passively accepting risk's dictates, take an active role, utilizing the tools that the market provides, and exercise their ability to control risk, instead of remaining at its mercy.

Risk takes many forms, depending upon the particular financial instrument, but it is ever present. Indeed, multiple risk factors may be acting simultaneously. For example, fixed income securities contain credit risk, interest rate risk, reinvestment risk, and prepayment risk, among others, while equity securities primarily face volatility risk, that is, the deviation of the security's actual return from its expected return. (Additionally, contingent on the financial market in question and the investor's particular perspective, other risk factors such as liquidity risk and currency risk may come into play.)

All risk can be eliminated[1]. Some risk management techniques come at a cost, which also lowers a portfolio's expected return, others are available for free, which does not affect a portfolio's expected return.

Hedging[2] is a highly effective risk management tool, but it costs money (e.g., the cost to purchase a put option on a common stock position). Portfolio hedging is analogous to purchasing automobile insurance. An investor pays a known premium, and consequently accepts a negative return on that payment, in exchange for eliminating the possibility of a catastrophic loss. This is equivalent to a driver paying an insurance premium to offset the unlikely but possibly large loss stemming from an auto accident.

An alternative risk management tool, and one that we utilize every day for our client portfolios, is diversification. In contrast to hedging, this technique does not decrease a portfolio's expected return. Diversification, rather than a cost, is a free opportunity for investors to exploit.

To effectively diversify a portfolio it is necessary to desegregate total risk into its two components: systematic risk and unsystematic risk, but it is easier to refer to them as diversifiable risk (company-specific risk) and non-diversifiable risk (market risk). This distinction simply recognizes that some risk is inherent and cannot be eliminated through diversification, but a significant portion of the total risk can be eliminated. This is where the free opportunity lies.

Academic studies on the benefits of diversification vary, but have generally shown that the potential gain is not meaningful owning beyond 30 securities.

Figure 1 illustrates this concept. (Please see the Appendix on page 3.) The graph shows that total risk equals diversifiable risk plus non-diversifiable risk. The curved line tracks the decline in the portfolio's total risk as the number of securities increases. It also shows that non-diversifiable risk acts as a floor beyond which risk can no longer be freely eliminated. The line's concave curvature (or bowl-like shape) signals that diversification has diminishing benefits, simply meaning that at some point the added benefit gained through additional securities is not economically significant.

In contrast, highly concentrated portfolios holding a few securities, where security selection is emphasized over portfolio construction, are foregoing this free opportunity and consequently are placing their assets needlessly in peril. The bottom line is that all risk cannot be freely eliminated, but the portion that can be, certainly should be.

Below is an excerpt from an article in Bloomberg Wealth Manager Magazine (July/August 2004) titled *"Headed for a Fall"* which provides insight into the topic of diversification:

[1] Although all risk can be eliminated, ultimately investors are being compensated for bearing risk and therefore eliminating all risk would be counterproductive (i.e., this would produce an expected return of zero).
[2] Hedging involves using derivatives to gain an exposure that will act oppositely of the assets in the underlying portfolio. Although not free, it can be a cost effective and tax efficient risk reduction tool. For more information, please contact our office.

> **Perhaps the most widespread—and potentially damaging—mistake made by individual investors (and professional money managers) is the failure to adequately diversify their holdings. Affluent individuals in particular often have too much of their wealth concentrated in a single position. Many created their wealth through entrepreneurial endeavors, others by exercising stock options, and still others may have inherited shares of stock through estate transfers.**
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> **Each of these examples may result in a different emotional frame of reference, and the respective investors have different motivations for holding on to their concentrated positions. Those motivations include greed, overconfidence, and aversion—either to paying taxes on their gains or to regret that the stock will continue to run up after they sell. Often times it is simply a case of inertia—the stock has done well, and they see no reason to change.**
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> **Regardless of the reason, the result is the same: individuals with concentrated stock positions are taking unwarranted risk. One of the fundamental principles of modern portfolio theory is that investors can mitigate all risk except market risk through prudent diversification. What's more, it's now generally recognized that over the long term the market does not reward those who take risk that can be diversified away. In other words, when investors hold too much of their wealth in concentrated holdings, they are not adequately rewarded for the additional risk they are taking.**
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> **The reality is, there is no non-emotional reason to have more than 5 to 10 percent of a family's net worth tied up in a single stock.**

We, too, believe it is prudent to invest no more than 5 to 10 percent in a single equity position, and that is why we look to hold approximately 30 positions in our clients' common stock portfolios.

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Each of our firm's clients is unique and each has different investment goals. We work efficiently and in a disciplined manner to design investment solutions to meet the needs of clients. Proper risk management is a central need for every client. We hope this letter illustrates how our firm provides for this particular need.

We welcome you to call our office at (918) 295-9929 if you have any questions or need assistance anytime. We are always available to help and we appreciate your trust and confidence.

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