

Balancing Act



As managing director of the Alternative Solutions Group, **Michael Leon** develops risk management strategies for clients who have concentrated equity positions or who are seeking to hedge and manage interest-rate risk. Michael holds a B.A. in economics from the University of Wisconsin-Madison.

From sudden geo-political events and volatile swings in the economy to a host of other uncertainties, investors can face myriad risks with costly consequences. Michael Leon, managing director of Northern Trust's Alternative Solutions Group explains why risk management is more important than ever in today's environment.

Why is risk management so important for investors today?

We all know the financial markets are volatile, and the dot-com crash in 2000-2001 only reinforced that. The economic situation both in the United States and throughout the world can change, causing fluctuations in stock values. Interest rates may rise or inflation may become a problem. The financial markets are susceptible to many different factors.

And risks exist at the individual stock level as well. While the Enron and WorldCom scandals highlighted the potential dangers of single stock concentrations in an investor's portfolio, even routine business cycle events — product changes, regulatory changes or major litigation — can affect the value of an individual stock.

Investors can never totally eliminate risk. But by using proper risk management strategies, we can help identify yield and return opportunities for investors. That's why risk management should be an integral part of any investment strategy.

What is one of the biggest risk factors you see investors facing today?

Today, one of the biggest risks facing investors is an over-concentration in their portfolios of a

single stock. The average individual stock has twice the volatility of a diversified portfolio, but has the same expected return. This volatility can pose a serious threat to an investor whose portfolio is too concentrated in just one stock.

A typical investor in this situation might be a corporate executive with substantial stock or stock options, a business owner who received stock in lieu of cash in the sale of his or her business or someone who inherited a large block of stock. For these investors, diversifying their portfolios can help them optimize risk and return. We can accomplish this by employing a number of different strategies, including options-based hedging, planned giving, exchange funds, or the sale and reinvestment of the concentrated security.

How might a risk-management strategy work for someone with a concentrated holding of a single stock?

In the case of executives with substantial stock and stock option holdings in the company they work for, we might recommend a customized sale strategy with a 10b5-1 plan.¹ This plan allows for the systematic sale of stock and stock options over time, without window period restrictions. For business owners who are selling their businesses

through a stock-for-stock sale, we have used exchange funds to help them diversify tax-efficiently. The owner's concentrated stock can be exchanged for an interest in a diversified portfolio, which will help minimize risk and lower volatility. In most cases, the exchange fund provides the most tax-efficient strategy for diversification because the investor pays no taxes at the time he or she enters into the transaction.

You also mentioned risk related to rising interest rates. How can an investor manage interest-rate risk on bank debt?

Interest rates have been rising steadily during much of the past two years. This has driven up the cost of variable-rate loans. Rising rates not only impose a direct cost through higher interest payments, they also can hurt asset values. The ever-present threat of inflation could send interest rates even higher over the next few years. To help mitigate the uncertainty, investors need to look for alternatives that allow them to fix rates on loans made today and in the future.

We can help investors fix the cost of their interest-rate liabilities and provide them with an array of alternatives and develop a solution specifically built around their situation.

In what type of situation might an individual benefit from interest-rate risk management?

Real estate developers with substantial property, business owners and even affluent individuals have specialized capital needs. They can benefit from flexible solutions for transactions such as buying personal or commercial real estate, purchasing fixed assets, or financing or purchasing aircraft or yachts.

Take the case of a corporate executive who wants to finance the purchase of a



Illustration by Dave Cutler/Images.com

\$25 million jet over 10 years on a fixed-rate basis. The executive plans to take delivery of the jet in two years, but wants to mitigate the interim interest-rate risk by essentially fixing the rate now. In this situation, we might suggest using a variable-rate loan that is hedged to reduce risk.

This strategy essentially locks the interest rate today, removing a tremendous amount of uncertainty and mitigating the risk if interest rates rise during the next two years.

Do you think risk management is becoming more important for people to consider as part of their overall investment strategy?

As we all know, uncertainty is here to stay. Will the economy make a soft landing or will we slip into recession? Will energy

prices suddenly spike or recede? Will the ever-present threat of inflation spark another round of interest-rate hikes? While we are not fortune tellers, we can provide clients with customized solutions to help them manage risk based on their specific needs and risk tolerance.

Whether on the asset or liability side of the balance sheet, people are looking for comprehensive solutions that manage risk and minimize uncertainties in the marketplace. No investment strategy is complete without them. ■

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