

UN-MEASURED IS UN-MANAGED

A Story About UNCOMPENSATED RISK

Part Two

Envision this: You start out with an inheritance or court award and all in U.S. T-Bills. At that point there is no Compensated Risk or Uncompensated Risk (UCR). But, during the asset allocation process, including Mean-Variance Optimization, UCR is created and even made worse by constraints on one or more investments or sectors. So what is UCR??

Uncompensated Risk Defined

Investment Risk is risk that can be eliminated with diversification and unlike systematic or compensated risk, investors cannot expect added return for assuming more uncompensated risk. Uncompensated risk comes from the inherent risk of having too many of industries, sectors, firms that are closely correlated or uncorrelated. Uncompensated risk represents approximately 2/3 of total portfolio risk according to Richard A. Brealey author of Principles of Corporate Finance 10th Edition. <http://precisionfiduciary.com/glossary/>

Think of it This Way

REMEMBER THE BAD APPLE ANALOGY



Sector A

Sector B

Sector C

Sector D

etc

The asymmetrical nature of the problem is best illustrated by the proverb: “one bad apple spoils a barrel (sector)!” It applies to prudent diversification of a portfolio because allowing a “bad apple” security (one that increases a portfolio’s UCR) to remain in a “barrel” compromises the entire portfolio because it contaminates the other securities by making them less of a diversification factor.

The law says you must prudently reduce UCR and in order to do so a second step has to be measuring the amount of UCR in a constrained portfolio and to identify those assets that carry the UCR plague. In order to comply and enhance the portfolios returns with less risk you must take out the “bad apple” investments and replace them with low-closely-correlated assets that also contain low semi-deviations maybe peppered with a small weighting for momentum. It takes an algorithm likes ours to do this and usually has the effect of a higher Sharpe Ratio when these seemingly minor but significant changes are made.

See the dissimilarity between CR and UCR - <http://precisionfiduciary.com/PrudentRisk/>

Watch for Part Three of Un-Measured is Un-Managed next week.

and

Save the date for our AICPA webinar at 12:45 pm EDT on June 19, 2019

Offices in
Bingham Farms, MI & Aptos, CA
<http://precisionfiduciary.com/services/>

Stewart Frank, CPA/PFS, AIFA

Tel: 248-227-8208

Fax: 248-258-5567

Email: sfrank@precisionfiduciary.com

J Ben Vernazza, CPA/PFS, TEP emeritus

Tel: 831-239-6000

Fax: 831-685-8233

Email: BenV@CPA.com