Not so long ago, market risk seemed as remote to most investors as the worry that the Dow would drop 5,000 points from its high, or that bonds would outperform stocks over a 10-year period. Markets were relatively calm, and assets normally known for their volatility — emerging-markets equities, for example, and a wide range of commodities — were moving higher and higher. In those circumstances, putting controls in place to protect your portfolio from risk might have seemed an unnecessary hindrance. But economic and market environments can change quickly, and now no one needs to be reminded of just how real investment risk can be.
In the mayhem of a major market correction, investors who bought equities during good times often panic and sell at depressed prices, shrinking their wealth and taking themselves out of the market when it might be on the verge of recovery. Active traders who ignore risk controls, meanwhile, fall prey to unanticipated volatility. Experiencing an unusually large loss can paralyze an investor even as losses mount.

Succumbing to emotion, rather than relying on discipline, is not typically the path to success in any market, much less a turbulent one. “Whether you are a long-term investor or a short-term trader, whether you use fundamental or technical analysis, if you neglect risk control, the consequences are often disastrous,” says Bennett McDowell, founder and President of TradersCoach.com, which makes software for technical traders. “A better outcome is likely to await those who understand what’s at stake and who employ strategies that may help curb losses and preserve potential gains.

Spreading Your Vulnerability

Long-term investors should consider establishing a broadly diversified portfolio and rebalancing periodically. Owning many kinds of assets makes it more likely that at least some will perform well when others falter. Your mix of investments should also be in sync with your investment goals and make the trades needed to help bring your portfolio into balance. Or you could choose a simpler solution, such as a lifecycle fund in the series of TDX Independence Target Lifecycle Funds (ETFs), designed to adapt allocations automatically as investors approach the time when they’ll need investment proceeds, such funds can serve as core investments.

Trading With Risk in Mind

Risk-control measures can also be worked into trading parameters. Suppose you want to buy a stock or an ETF. Before actually placing your order, it makes sense to consider how your plans could go wrong. How wrong can you afford to be? And how will you respond to that miscalculation? “Your answers to those questions can help determine the number of shares you decide to buy,” says TD AMERITRADE’s Jay Pestrichelli, Managing Director of the Trader Group. “Building a trade properly can help protect you against large losses.”

Start by defining the maximum loss you are willing to sustain on a trade, Pestrichelli suggests. A common guideline is to venture between 2% and 5% of your portfolio. While you wouldn’t pursue an opportunity unless you expected it to pan out, keep in mind that even the best investors don’t profit every time. In the simplest terms, the goal is for your gains to exceed your losses, and that’s often a matter of letting profitable positions ride while cutting losing investments.

The next step is to establish a downside exit point. That’s the price at which you admit that your thesis about the investment was incorrect. By knowing that price before you buy, you are protected from the common mistake of waiting in vain for the position to recover. That wastes time and, again, money. At this point, the exit stops — $115 or $90 — is reached. Execution at one of these price points will not guarantee an execution at or near the activated trailing stop price. Once activated, it will compete with other incoming market orders.

Controlling risk is an ongoing process, Pestrichelli says. Evolving market conditions may change your outlook for a particular security, and that could require adjusting your exit targets. Moreover, there are additional strategies that may be used for hedging risk, including using options. For example, you could buy a put option — which gives you the right to sell the underlying stock at a specified price — to help limit your downside exposure on a long-term holding. And if the stock price falls, the value of the option may increase, potentially offsetting the loss on your shares. Of course, if the stock price trades sideways or rises, the puts will likely lose value and expire worthless resulting in a potential loss of the entire amount you invested in your option.

Now that many investors are focusing more attention on managing risk in the investment markets, investors need to explore the many ways to keep it at manageable levels. But with higher risk comes higher potential returns, and properly using options in your portfolio now could put you in place for well-earned gains when markets begin to recover.

To learn more, log on to your account and click Education to visit TD AMERITRADE’s new Education Center. (5)

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See “Important Information,” page 21, to reference the number following this article.

— Bennett McDowell
TD AMERITRADE
TD AMERITRADE branch office.

“People who trade on a short-term basis should do it with no more than 10% of their investable net worth and diversify the rest.”

— Bennett McDowell