Managing Equity Risk: Some Rules for the Road

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Under the surface of May's strong equity returns were major shifts in sector leadership, notably a rotation from defensive to traditional cyclical sectors. Given the market's tendency to change gears, it helps to be flexible in managing portfolio risk. In fact, it should be a daily exercise.

Here are a couple rules for the road that can help investors balance long-term conviction with the ability to respond to near-term challenges and changing environments.

Manage position sizes dynamically. Conviction is critical in equity investing—it's impossible to outperform the market if you're constantly second-guessing your research conclusions. But being confident that you're on the right course with a specific stock doesn't mean you can't be adaptable in an unforgiving stretch.

Even if the long-term prospects for a company are bright, a challenging near-term environment can still hurt its stock. Adjusting expectations and the size of the position dynamically can lessen the pain of a temporary impairment without having to give up on the stock altogether. As long as the long-term thesis is intact, there's nothing wrong with playing a little defense when needed.

Take IBM. A year or so back, the tech giant seemed to be on top of its game fundamentally, but there were signs that technology spending by IBM's corporate customers could enter a weak patch, creating near-term headwinds. An IBM investor could hold on for the ride or get out—or manage the position size down to reduce exposure until things cleared up.

In the end, the latter option likely would have worked out pretty well. After limping through a disappointing earnings period, IBM steadied itself, and ended up a strong performer. The outlook for tech spending improved, too. Reducing exposure to IBM during that rough stretch could have reduced potential damage while retaining some exposure that could be ramped back up as the picture began to improve.

Adjust sector exposure to tailor portfolio beta. Portfolio adjustments can be made more broadly, too. Most portfolios have exposure to many sectors—each with a different sensitivity or responsiveness to the direction of the broader equity market. Sectors such as consumer cyclicals (think cars, retail stores and entertainment) tend to outperform when markets rally on economic strength and underperform in downturns.

In contrast, defensive sectors, such as utilities and consumer staples, tend to be less economically sensitive, because their products are largely everyday necessities for customers. Somewhat counterintuitively, growth-oriented stocks also tend to be less sensitive to general economic weakness—their stock values tend to be driven more by company-specific factors over time.

The mix of cyclical, growth and defensive stocks that makes up a portfolio influences its overall market sensitivity, or beta. By adjusting the sector mix, a portfolio's beta can be dialed up to take advantage of a stronger market environment or toned down to operate with more restraint in a less favorable period.

Let's say that a look at the macro and market environments suggested trouble ahead. In that case, a portfolio could be shifted to create a more defensive and secular-growth tilt that might weather a downturn more effectively. If the outlook were more positive, a shift toward cyclicals could better position a portfolio to take advantage of a strong market.

The name of the game with this approach is flexibility. Conviction in long-term stock ideas and equity potential are good things. But the market can change its mind on short notice—often daily. Constantly adapting in response can help a portfolio better navigate the twists and turns.

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