

Investment Pros Want No Part Of Current Risk

Threat of War, Weak Economy, Terrorism Leave Money Managers With Little Stomach for Business

By E.S. BROWNING

ABREAST OF THE MARKET

PROFESSIONAL MONEY managers are paid to manage risk. Yet these days, in the middle of one of the shakiest periods for investors in months, managing risk is what many of them aren't doing. Instead, they are running the other way.

A looming war, the threat of terrorism and a slumping economy are immobilizing the stock market. And it is professional money managers, who usually spend their days analyzing risks and figuring out what they mean for stocks, who are as frozen as anybody.

According to a monthly survey by Merrill Lynch, global money managers are more risk-averse than at any time since the days following the terrorist attacks of September 2001—a tentativeness that is quickly spreading to the broader market.

Trading volume last week, for example, was exceptionally thin, featuring some of the lightest trading days of the year. Instead of actively managing their holdings, many money managers have built portfolios that simply mimic the stock indexes—spreading their holdings out among a variety of stocks in hopes of avoiding error, says Merrill Lynch chief global investment strategist David Bowers, who conducted the fund-manager survey.

"People have very few reference points. They aren't confident of anything," Mr. Bowers says.

Some professional investors say they aren't convinced investment risk can be calculated right now, and their failure to make such a calculation could leave them open to unwelcome surprises.

"I fear that asset managers are not taking this geopolitical risk as seriously as they should," says Duke University finance professor Campbell Harvey, who studies the effect of global risk on money management. "Because of all this uncertainty, a lot of asset managers are simply electing not to do this kind of analysis."

Certain experts on risk management worry that investors may have their heads a little too deep in the sand—which may expose them to more risk, not less.

"The big question now is whether this is a 'value trap,'" he says, describing a situation where stocks look cheap, but where economic and political concerns keep investors away. "So they just stay cheap," Mr. Bowers says.

Some stocks did make progress last week. A gain of 103.15 points, or 1.30%, on Friday helped push the Dow Jones Industrial Average back above 8000 to 8018.11, up 109.31 points, or 1.38%,

for the week. But it remains down 4% so far this year, and is trading back where it was in mid-October, shortly after it rebounded from a five-year low.

In a normal world, optimistic investors would be grabbing stocks with both fists right now, says John Leo, who leads a group of portfolio managers at money-management firm Northern Trust in Chicago. Instead, he says, money managers "are worried about war, terrorism and corporate governance."

And that is just for starters, Mr. Leo says. "On top of that, you have the dislocation in the Venezuelan oil supply, a budget deficit at the federal, state and local levels, and worries about whether consumer spending can hold up."

That certainly sounds like a world in which doing nothing would be a logical impulse. But Peter Bernstein, an economic consultant to institutional investors and author of the book, "Against the Gods: The Remarkable Story of Risk," says that, as counter-intuitive as it may seem, the world is now, and always has been, in an uncertain state. His view is that, in a mathematical or investment sense, the world never is a predictable place, even when it seems to be.

Three years ago, for instance, the bull market topped out and the long, painful bear market began. Although it didn't seem that way at the time, that actually may have been a riskier period, from an investment standpoint, than today.

The idea of managing risk, Mr. Bernstein says, isn't to try to predict the future, but to balance and hedge your investments to reflect the financial risks that you can identify.

For some investors, delay may not appear to be such a bad strategy. Mr. Leo, for example, already had a portfolio heavy on "defensive" stocks. Those are companies whose sales tend to be stable regardless of the world situation, such as makers of drugs, food and household products. Those stocks often are steadier in uncertain times.

But Prof. Harvey of Duke argues that even some fund managers who think they are being defensive may not be doing enough to protect themselves. His calculations suggest that risks today are skewed sharply toward negative events. War and terrorism could throw the

U.S. and world economies into recession, he says. But the Standard & Poor's 500-stock index still is trading at more than 20 times its companies' earnings for the past year, well above its historic average.

"That makes the upside possibilities muted compared to the downside possibilities," he says. He calls it "naïve" to believe that such a high-priced stock market will react to this war as positively as it did to the Gulf War and its buildup in 1990-1991.

A quarterly survey of corporate chief financial officers conducted by Duke, in cooperation with a group of business executives called Financial Executives International, shows that chief financial officers are unusually nervous right now.

Ordinarily, finance chiefs consider the short-term safer and more predictable than the long term. That shows up in something called the equity risk premium—the extra expected return that investors need to persuade them to move money to stocks instead of government bonds, which are considered safer.

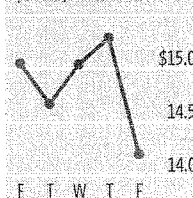
Since December, Prof. Harvey says, risk expectations have been turned on their head. Financial officers now rate the risk premium higher for a short-term investment than for a longer-term one. That means that, unusually, they worry more about the next few months than they do about the next few years.

To Prof. Harvey, that also means that investors should be taking a much more defensive posture, leaning more toward Treasury bonds and blue-chip corporate bonds. At the same time, he says, they need to protect themselves against the "risk" that the crisis will be resolved and the stock market will soar. To do that, they could maintain a smaller position in volatile stocks that might soar in case of good news, such as speculative tech stocks.

Mr. Bernstein, the author, takes a slightly different approach. Since he

Meridian Gold

\$14.20, down 7.1%



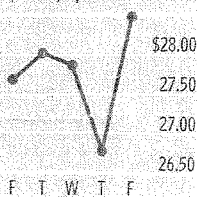
knows it is impossible to predict the future, his goal is to build a portfolio that will do well regardless of future storms. How? Through diversification and hedging.

That means owning U.S. stocks, in case a positive outcome sends stocks soaring. But it also means owning gold, foreign-currency investments and other hedges against a possible plunge in U.S. stocks.

"Maybe this is going to have a happy ending. I'm not quite sure how, but anything can happen," he says. At the same time, "you have to hedge against extreme outcomes today to a degree that you probably didn't have to two years ago. If the range of outcomes is wide, your diversification has to be as wide as possible."

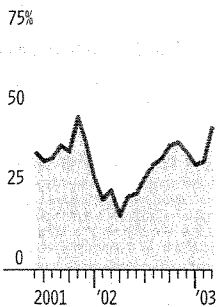
Target Corp.

\$28.48, up 6.4%



Risk Averse

Global money managers who say they are taking less risk than normal in their portfolios.



Source: Merrill Lynch