

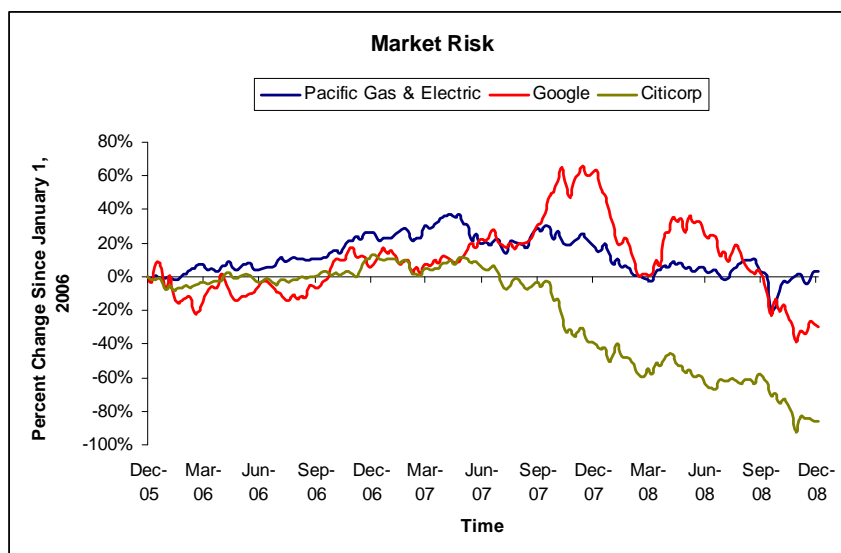
Spotlight on Market Risk and Volatility

Featured in the spring 2009 issue of Contango Capital Advisors' newsletter

Market risk is a chance that an investor takes. No matter what the long-term prospects of an investment or its probable intrinsic value, an asset may trade at any price in the market. A trading price is determined by the interactions of buyers and sellers. If there is more buying than selling of an asset, its price will rise; if there is more selling than buying, its price will fall. This means that an investment's price can rise, fall and bounce around. The extent of these movements is usually described by the term *volatility*.

We describe Pacific Gas and Electric Company's stock as having low volatility because it has relatively small price fluctuations, whereas a highly volatile investment like Google stock will be subject to relatively larger price swings. Because the extent and timing of these bounces is unpredictable, the possibility exists that any asset could trade for a price that is lower than you might rationally expect. For investors, these bounces can be a source of concern when they create unrealized losses in a portfolio.

The real risk to investors, however, is that they might need to sell an asset at a relatively low price, thus turning an unrealized loss into a realized one. Also, investors may be forced to write off an asset if it loses its entire market value (traded value equals zero).



Source: Bloomberg

Nobody can predict the future. Therefore, we can only estimate when and by how much market sentiment might reverse itself, which types of assets might recover, and which become permanently impaired, as perhaps Citigroup could be. Because investors demand compensation for this risk, a portfolio of more volatile assets will often produce higher long-term gains than a portfolio of less volatile ones, but not always.

We mitigate volatility by diversifying. Because we do not expect all assets to move up and down in lock-step, we smooth out portfolio returns by investing in a broad range of assets. Diversification allows us to balance the ups with the downs and to limit the impact of any asset going to zero. We do not put all our eggs in one basket lest the basket turns out to resemble Citigroup at the end of 2008.

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