

Balancing Your Return Ideals With the Realities of Risk

Step 1: How Do I Know What to Expect From an Investment?

Every builder starts with a foundation. If you are new to investing, you are building an investment portfolio, and you need to start with an investment foundation. That foundation consists of the basic investment principles.

Boiled down to its bare basics, investing concerns returns and risks.

An investor's return consists of current income, plus capital gains due to growth, minus any losses from the investment.

Return = current income + capital gains due to growth - any losses

Sounds simple, and it is, except that most investors would prefer to know the return before making the investment.

Absent a crystal ball, investors can only make an educated guess as to what kind of return to expect. If an investor's actual return turns out to be different than the return he expected, he could suffer an unexpected loss.

Of course, an investor's expected return must be reasonable. Expecting a return of 25% just because your stockbroker says that's what you'll earn is not reasonable. Most expectations are based on what happened in the past, and unfortunately history doesn't always repeat itself. On the other hand, there is little else to go on, and reasonable conclusions about future returns can be reached by looking at the past, tempered with the understanding that these returns aren't guaranteed.

Even if your expectations are reasonable, however, there is the possibility that your investment's actual return will be different than expected. This is the risk you must take on as an investor, and it includes the possibility of losing some or all of your original investment. Risk is greater when the possibility is greater that the actual return will differ from the expected return.

Put another way, the greater the uncertainty, the greater the risk.

What is uncertainty? The future is uncertain, and the longer you must wait for your return—or, the longer the time period over which you must make your educated guess as to return—the greater the uncertainty. In addition, the quality and stability of the investment is uncertain.

Investors can usually be more certain of their predictions on future returns for investments that have a greater income component because they will receive more of their return sooner rather than later. For instance, bonds that pay a fixed interest rate have more predictable returns than stocks, whose returns come primarily from capital gains.

However, this may be offset by uncertainty over the quality of the income payments—whether they will continue to be paid and how certain it is that they will continue at the expected level. A bond backed by the full faith of the U.S. government is more certain to meet its interest payments and pay back principal than a bond backed by a corporation that may or may not suffer financial difficulties.

Step 2: Why Don't Investments Always Live Up to My Expectations?

Investment uncertainty is not knowing what is going to happen to your investment. What could cause it to perform differently than you expected? There are several major sources of uncertainty, or risk, that could produce unexpected returns. They include:

- **Business and industry risk:**

The uncertainty of an investment's ability to pay investors income, principal, and any other returns due to a significant fall-off in business (either firm-related or industry-wide) or bankruptcy. A stock, for instance, may fall in value because a firm's earnings have unexpectedly dropped due to bad management calls or an industry-wide slowdown.

- **Inflation risk:**

The uncertainty over future inflation rates, which results in uncertainty over the future real (after-inflation) value of your investment. An investment that barely keeps pace with inflation will not be able to grow in real terms, leaving you with only as much purchasing power in the future as you have today.

- **Market risk:**

The risk that the general market or economic environment will cause the investment to lose value regardless of the particular security. A stock may drop in value simply because the overall stock market has fallen; this is referred to as stock market risk. A bond doesn't face stock market risk, but it may drop in value due to a rise in interest rates; this is referred to as interest rate risk.

- **Liquidity risk:**

The risk of not being able to get out of the investment conveniently at a reasonable price. This can occur for a number of reasons. If the market is volatile, you may be forced to sell at a significant loss if you must sell immediately. Another cause can be an inactive market. For instance, it may be difficult to sell a house simply because there are no buyers.

All investments face each of these risks, but the degree of risk varies greatly. For instance, stocks face much less inflation risk than bonds. Over the last 50 years, bonds have barely kept pace with inflation, while stocks have outpaced inflation by about 8% annually. On the other hand, short-term bonds and money market investments face little liquidity risk, while stocks face a greater liquidity risk, since you may be forced to sell at an inopportune time, suffering a large loss.

Step 3: How Can I Use Risk to My Advantage?

Ironically, it is uncertainty that creates the potential for higher returns. How? Because of the risk/return trade-off.

Every investor wants the highest assured return possible. But as we have seen, returns aren't certain, and different investors have varying degrees of uncertainty that they are willing to accept. In fact, each investor seeks the highest possible return at the level of uncertainty, or risk, that he is willing to accept.

In a competitive marketplace, this results in a trade-off: Low levels of uncertainty (low risk) are the most desirable, and are therefore associated with low potential returns. High levels of uncertainty (high risk) are the most undesirable, and are therefore associated with high potential returns.

Over the last 50 years, stocks have produced returns that average 12% annually; long-term bonds have averaged 6% annually and short-term Treasury bills have averaged 5% annually. These returns reflect the risk/return trade-off.

The trade-off, however, exists on average, not in every single instance: Remember, it's the uncertainty that's the risk. As an investor, you must analyze each investment, comparing the potential returns with the risks. On average, the potential returns from an investment should compensate you for the level of risk undertaken. If they do not—for instance, low potential returns associated with high risk—you should not make the investment.

The trade-off also serves as a warning flag—high potential returns usually flag high risks, even when those risks are not obvious at first glance.

Step 4: Are There Ways to Reduce My Risk?

While potential returns should compensate you for risk, there are some risks that you will not be compensated for, and therefore they should be avoided.

If you invest in a single security, your return will depend solely on that security; if that security flops, your entire return will be severely affected. Clearly, held by itself, the single security is highly risky.

If you add nine other unrelated securities to that single security portfolio, the possible outcome changes—if that security flops, your entire return won't be as badly hurt. By diversifying your investments, you have substantially reduced the risk of the single security. However, that security's return will be the same whether held in isolation or in a portfolio.

Lower risk, similar return, better investment.

Diversification substantially reduces your risk with little impact on potential returns. The key involves investing in categories or securities that are dissimilar: Their returns are affected by different factors and they face different kinds of risks.

Diversification should occur at all levels of investing. Diversification among the major asset categories—stocks, fixed-income and money market investments—can help reduce market risk, inflation risk and liquidity risk, since these categories are affected by different market and economic factors.

Diversification within the major asset categories—for instance, among the various kinds of stocks (international or domestic, for instance) or fixed-income products—can help further reduce market and inflation risk. And as shown in the 10-security portfolio, diversification among individual securities helps reduce business risk.

The importance of diversification can be seen by restating it in the negative: If you don't diversify, you are taking on a considerable risk for which you will not be compensated.

Time Diversification

There is one other type of diversification that is extremely important yet often overlooked—time diversification, remaining invested over different market cycles.

Time diversification helps reduce the risk that you may enter or leave a particular investment or category at a bad time in the economic cycle. It has much more of an impact on investments that have a high degree of volatility, such as stocks, where prices can fluctuate over the short term. Longer time periods smooth those fluctuations. Conversely,

if an investor cannot remain invested in a volatile investment over relatively long time periods, those investments should be avoided. Time diversification is less important for relatively stable investments, such as certificates of deposit, money market funds and short-term bonds.

The best example of the benefits of time diversification is in the stock market. During the infamous month of October 1987, the stock market suffered a loss of over 20%. But do you remember the return for the entire year? If you had invested at the beginning of 1987 and remained invested through year-end, you would have earned 5.2%, not stellar, but certainly better than a loss of 20%. Longer time periods illustrate the point further. For instance, over the five-year period from 1987 through 1991, which includes the market crash, you would have earned an average 15.4% annually if you had remained fully invested in the market, with actual annual returns varying between -3.2% in 1990 and 30.5% in 1991.

Time diversification also comes into play when investing or withdrawing large sums of money. In general, it is better to do so gradually over time, rather than all at once, to reduce risk.

Step 5: How Do I Balance the Risks Against My Expectations?

The foundation of your investment portfolio rests on the investment principles of risk and return:

- Returns are not known in advance. Instead, investors must make their decisions using return expectations, which should be reasonable and mesh with reality.
- All investments are made with the possibility that your actual return won't meet your expectations.
- The uncertainty surrounding the actual outcome of your investment creates risk; the greater the uncertainty, the greater the risk.
- There are many reasons why your expectations may not materialize, and you should be aware of all of them, including: business or industry risk, inflation risk, liquidity risk and market risk.
- All investments face each of these risks, but to varying degrees.
- There is a trade-off between risk and potential return: the higher the potential returns, the greater the risk, and the lower the potential returns, the lower the risks. Conversely, be wary of claims of high returns with low risk.
- In a portfolio, some risks can be reduced or eliminated with little effect on return through diversification. Always diversify among asset categories (stocks, bonds, cash), within asset categories and among individual securities.
- Diversification is also important across market environments—the longer your holding period, the better. Don't invest in stocks or other volatile investments if you will remain invested for less than five years.
- Do not take on risks for which you will not be compensated. In building your investment portfolio, you are simply seeking answers to these questions:
 - What are the risks?
 - What risks can be eliminated or reduced through diversification and which risks will remain?
 - What are the returns associated with the risks I will be undertaking?

The answer to the last question is a balance of those risks and potential returns, based on your investment profile—your personal circumstances and personal tolerance for risk. Once you have gained your balance and have a steady foundation, you can finish building your portfolio