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Is Investment Risk Necessary?

There is a school of thought among some financial professionals that says "To make money, you have to be willing to lose money," by investing in volatile and non-guaranteed financial instruments, such as stocks, bonds, mutual funds, ETFs, limited partnerships, etc.

Adherents to this approach almost always point to historical, mathematical evidence. They have analyses that show which asset classes have kept pace with inflation, or which investments, despite their fluctuating values, have delivered superior average returns. For them, the numbers are clear: Investment risk is necessary. And done correctly, the results, while not guaranteed, have been better than "safer" alternatives.

This steady stream of mathematical "proof" has convinced a large segment of the American populace. As one financial professional puts it, "People take investment risk because the financial services industry has told them it's safe to do so."

But is this true? When you begin to integrate the human factors with the math, there's a slightly different picture. There are risks not only from the nature of the investments, but also from investor behavior. It is because of this combination of unpredictable action, that Bob Seawright concludes in a Summer 2017 *Research on Wealth* article, "Investing successfully is really hard."

Asymmetric Returns, Consistent Volatility

Returns from non-guaranteed asset classes are usually asymmetric. They do not occur consistently or in recognizable patterns, and profits or losses may be concentrated in particular asset classes at particular times. Even broad evaluations over longer time periods show this asymmetry; movement is sporadic, unpredictable.

Look at the real growth of a dollar invested in the S & P 500 for the following periods:

1929-43:	**$1.08**
1944-64:	**$10.83**
1965-81:	**$0.94**
1982-99:	**$11.90**
2000-present:	**$1.35**

Not only are returns asymmetrical, the winners are rare. Hendrik Bessembinder, a finance professor at Arizona State University, has compiled a database on the performance of nearly 26,000 stocks going back to 1926. Among his findings:

- **58% of all stocks underperformed one-month U.S. Treasury bills**, and a majority of these stocks lost money over their lifetimes. A Treasury bill (T-Bill) is a short-term debt obligation backed by the U.S. government with a maturity of less than one year. T-Bills are attractive to investors because they offer a very low-risk way to earn a guaranteed return on invested money. If the long-term performance of almost 60 percent of stock investments doesn't match that of T-Bills, why take the risk?
- **A few big winners make the overall averages look good.** Bassembinder finds that "The entire net gain in the U.S. stock market since 1926 is attributable to the best-performing four percent of listed stocks, as the other ninety six percent collectively matched one-month Treasury bills."

While gains might be asymmetric, volatility is consistent. A February 2017 study by Ben Carlson found that between 1930 and 2016, almost half of those years featured moments where stocks experienced declines of 10% or more. These losses were often regained or exceeded in the course of a year, but the fluctuations are emotionally challenging. As Seawright says: "Here's an important corollary to my primary thesis: Even great investing is really hard to abide (because) even the best possible portfolios suffer huge (and thus terrifying) drawdowns. Here is the bottom line: Perfect foresight demands great returns, but still demands gut-wrenching drawdowns. Even if we could hire God as our money manager and He always picked the top stocks in advance, most of us would still fire him for the drawdowns – many times over!"

The Best Approach to Investment Risk

This gets to the heart of the matter: Over long periods of time, returns from non-guaranteed asset classes may be historically superior – but only if investors maintain their positions. This is sometimes referred to as "perfect investor behavior," the ability to ignore asymmetry and volatility in order to have the best possible chance of realizing the long-term potential from non-guaranteed asset classes.

If you are aware of the interplay between the characteristics of non-guaranteed assets and human behavior, follow these strategies when considering investment risk:

1. Better to always save 15% of your Gross Income (GI), and take less risk. The driving idea behind taking risk is the need for investment returns to make up for a lack of saving. But if you save properly (15% of GI to keep up with taxes, inflation, technological change and plan obsolescence) you won't have to take additional risk.
2. The best approach to limit your investment risk is to limit your exposure. If you limit your exposure to 25%-35% when investing in volatile and non-guaranteed financial instruments, the impact will not be that significant during market declines.
3. Take investment risk because you can, not because you have to. The best chance of having perfect investor behavior is knowing you have enough savings to ride out the fluctuations, or afford a loss. If your financial situation sees investment risk as the only way to achieve your financial objectives, perfect investor behavior is unlikely – and so is success.

Practically and psychologically, these strategies will prove to be effective.

In short, the best approach to investment risk is to simply limit your exposure to 25%-35% of invested assets. ❖

All investment contains risk and may lose value. Past performance is not a guarantee of future results.

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