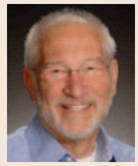
PORTFOLIO STRATEGIES

Making Sense of Investment Risk

While you can't completely avoid risk when investing, there are practical ways to protect yourself from specific emotional, behavioral and financial risks.

BY PAUL MERRIMAN



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Most investors understand the basics of taking risks. We do it every time we buy a security.

Almost all the trouble investors get into involves risk. Sometimes it's taking too much. Sometimes it's taking too little. Often, it's failing to even recognize that a particular risk exists.

Most people aren't eager to think about risks. But on that inevitable day when one (or all) of your investments fails to live up to your dreams, you may wish you had paid more attention.

Risk comes in various flavors, but they all start with one unavoidable fact: The future is unknown. Some risks are objective, and you can measure them in money. Emotional risks manifest in stress, worry and uncertainty. Behavioral risks—doing the wrong things—can lead to financial losses and emotional stress.

I'll discuss some examples of each in the second half of this article. But first I want to explore the nature of risk, in the hope that this will help us know what to do (and what NOT to do) about it.

Part 1: The Nature of Investment Risk

As an investor, you have no task more important than recognizing and managing risk. But what is "risk," anyway?

One common definition of risk is the probability that any specific investment will decline in value. In the stock market, this happens almost every day, even if the loss is only temporary. Too many investors give all their attention to market risk while they show little concern for other risks that can hurt them much more over time.

Back in the late 1980s when Microsoft Corp. (MSFT) had just gone public and Bill Gates was suddenly worth hundreds of millions of dollars, he was asked how often he looked at the company's stock price.

His answer: About once a month.

Gates, of course, was making money hand over fist. But he understood that his eye had to be on the ball (doing his job) instead of on the scoreboard (calculating the value of his stock).

Much more important than today's stock prices are your long-term goals, your asset allocation and the recurring costs you are paying—to name just three. Calculating how you are doing does not help you make more money.

My Definition of Risk

My own definition of risk is unorthodox, but I think it's useful: Risk is a possibility, which you invite into your life, that you could lose something important. That something might be your physical safety, a relationship or something financial.

Whether you realize it or not, you actually invite risk into your financial life every time you invest your money.

My Guarantee

This isn't theoretical. Here's a guarantee I have made many times: If you invest in the stock market, you will lose money. Some level of temporary loss is simply inevitable, as Figure 1 shows.

When the market heads down, real people lose real money in real time. There is no way to avoid it.

Successful investors are those who learn how to react properly. When things are going well and everybody seems to be making money, investing is easy. Emotional risk is low. However, as prices keep going higher, financial risk goes up too. The higher you get on the upward curve, the closer you are to the point when that curve will start heading downward.

Conversely, when the market has been doing poorly, emotional risk is high, and fear is much stronger than greed. Ironically, this is the very time in the market cycle when financial risk is relatively low.

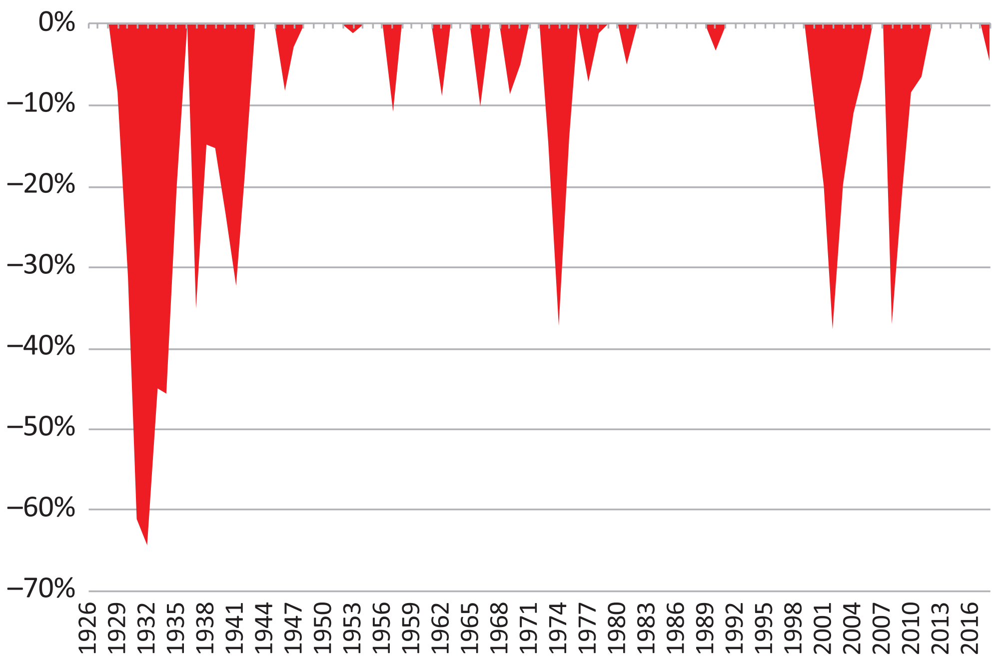
In practical terms, this means that if you let your emotions tell you when to get in and out of the market, you will do the wrong things. Fear and greed will lead you astray by prompting you to sell when prices are relatively low and buy when prices are relatively high.

This is counterintuitive, I know, but the best investors are those with the patience and the perspective to do the opposite of what the masses are doing.

FIGURE 1

Historical Drawdowns for Large-Company Stocks

Short-term losses in the stock market are inevitable. These temporary drops are also the times when financial risk is lowest and the reward for doing the opposite of what the masses are doing is the greatest.



Source: Roger G. Ibbotson and Duff & Phelps, "2019 Stocks, Bonds, Bills, and Inflation Yearbook" (Duff & Phelps, 2018).

What's the Answer?

I think the answer is moderation. Trying to get rich quick can be very dangerous. Giving up too easily is also dangerous.

Your best defense may be to have somebody you trust, whether it's a spouse, a friend or a professional adviser, who will slow you down when you're eager to do something that may be wrong for you.

Timeless Truths

Here are four "timeless truths" I have learned over the years:

1. Risk is normal; it shouldn't surprise you. Any stock market trend that goes in only one direction for a prolonged period should be treated with ample suspicion.
2. Stock and bond markets are unpredictable in the short term. No matter when you are reading this, I'm quite confident that many of the market predictions that were made one year ago were so wide of the mark that they turned out to be of little help.
3. Over the past 200 years, the world's stock markets have had a long-term upward trend, and I believe that trend is likely to continue. Capitalism appears to be gaining strength in the world, not losing it.
4. The market's immediate response to good news and bad news is almost always exaggerated. At times, many investors seem to believe that the entire future is wrapped up in the headlines of the day. But, in fact, the best response to short-term problems and uncertainties is usually to ignore them.

How Much Risk Should You Take?

How do you know whether you are taking too much emotional risk? To quickly get a handle on this, ask yourself three questions:

» Have I lost sleep over my investments?

» Do I feel a compulsion (not just curiosity) to follow the financial news and check prices daily or weekly?

» Does the financial news make me worry about my future?

If you answer yes to even one of those questions, you are probably taking too much risk.

You can hire professionals to allocate your assets, rebalance your portfolio, minimize your taxes and expenses and perform most of the other tasks that make up good investment practice. But you are the one who must deal with the emotional side of risk. It's a job you can't delegate.

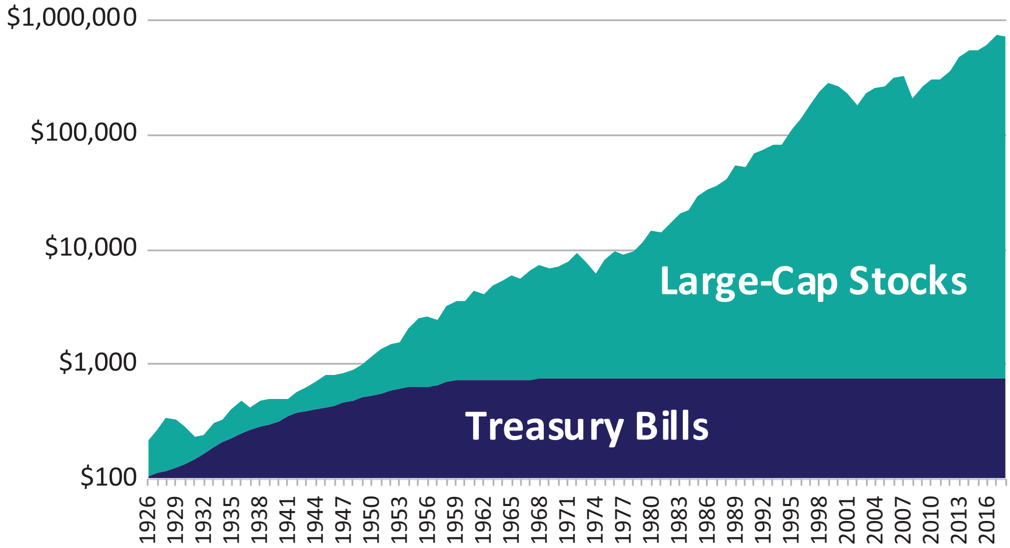
The important part is this: You can't achieve any long-term return unless you stick with the program that produces that return—and you can't stick with a program if it scares you out of your pants and out of your investments. At the other extreme, if you take too little risk and keep all your money in the bank or in T-bills, inflation will erode your purchasing power over time. (For a comparison of stock and bond returns, see Figure 2.)

As I mentioned: In the long run, moderation will serve you better than either too much ambition or too much caution. To hear a reading with more thoughts on this important topic, check out my "How Much Risk Will You Take?" podcast (https://paulmerriman.com/chapter-5-how-much-risk-will-you-take).

FIGURE 2

Growth of $100 Invested in Treasury Bills and Large-Company Stocks

While U.S. Treasury bills provide the illusion of safety, they erode your ability to buy goods and services over time. Investors need the long-term returns of stocks to preserve and increase their purchasing power.



Source: Roger G. Ibbotson and Duff & Phelps, "2019 Stocks, Bonds, Bills, and Inflation Yearbook" (Duff & Phelps, 2018).

Part 2: Specific Risks

Investors face three main categories of risk:

» Emotional risks that can be challenging to overcome because of the way we humans are wired;

» Behavioral risks—things we do that are not in our best interests; and

» Financial risks, which are independent of us as individuals.

Emotional Risks

Human psychology is a dangerous thing, and there are some alarmingly common mistakes people make again and again.

It is very easy to fall into these mind traps. We misperceive reality. We delude ourselves. We avoid facing uncomfortable facts. The list goes on.

Here are five emotional risks to watch out for:

1. **Superiority:** We humans tend to think of ourselves as "at least" above average. A recent survey revealed that 91% of drivers in Washington state believe they are better than average. In Oregon, the percentage was 84%. (Just how that math works, I don't know.) Investors who are sure they "know" more than the experts and more than most other investors make millions of dumb decisions every year.

   Protect yourself: Garrison Keillor said he and his contemporaries learned something over and over when they were growing up in Minnesota: "You're not so special."

2. **Anchoring:** We can get stuck in what we think, what we know and what we believe, even after things change to make our opinions, beliefs and knowledge obsolete.

   In the 1960s, I knew a man who was about to retire and who put all his family's investments into airline stocks. His rationale: If anything bad happens to the airlines, the whole economy will collapse. His family lost a lot of money.

   Protect yourself: When you're sure you are right, run your thinking past somebody knowledgeable who isn't trying to sell you something.

3. **Irrational exuberance:** This phrase was coined by former Federal Reserve chair Alan Greenspan to describe the mindset of investors who were sure that nothing could go wrong in a long bull market. So far this century, we've seen two painful reminders of how much can go wrong in the stock market.

   Protect yourself: Don't trust a bull not to turn on you; that's a sure way to get gored. Rather, make sure you have some of your portfolio in bond funds.

4. **Negativity bias:** We humans tend to give more importance to bad stuff than good stuff. Studies show that our brains give more weight to a single failure than to half a dozen successes. Negative financial news is more compelling than positive commentary. This can lead to unjustified fear and unwise investing decisions.

Negativity can become a self-reinforcing loop. We lose hope, without which we become unwilling to take risk. And without taking at least some risk, we can't succeed as investors.

Protect yourself: Establish a sound long-term strategy and then ignore the financial news.

5. **Sunk costs:** If you own a house, you probably know off the top of your head what you paid for it. In your mind, it has got to be worth at least that much. But what if you need to sell and nobody is willing to pay as much as you did?

   Millions of dollars' worth of opportunities have been frittered away by people who, like ostriches with their heads in the sand, acted as if they hadn't really lost money if they just held on. There's a word for this emotional risk: denial.

   Protect yourself: A sinking ship is a sinking ship; the sooner a captain does something about it, the better the outcome is likely to be.

Behavioral Risks

Behavioral risks involve dumb decisions and bad habits. They include:

1. **Not saving enough money for the future:** The first chapter in my upcoming book, "12 Million-Dollar Decisions That Will Shape Your Financial Future," covers this very point. It's a very short chapter, because it's based on the simple fact that you can spend a dollar only once.

   Spend it now and get something of value for it. Alternatively, save that dollar, invest it well, and sometime in the future you will get something that's likely to be much more valuable.

   Protect yourself: Put your savings on automatic. Just about any credit union, bank, brokerage house or mutual fund company will be happy to set that up for you.

2. **Thumbing your nose at "free" money:** This may seem hard to believe. But you would be surprised at how many people fail to take advantage of their employers' matching contributions to 401(k) and similar retirement plans. Instead of recognizing the matching funds as salary raises, millions of workers regard them as "costs" that eat into their families' income.

   Protect yourself: Make sure you're putting away enough to maximize any match that's coming to you.

3. **Following bad investment advice:** Unethical advisers understand that millions of investors want nothing so much as to be among the "winners" in the investment game.

   Those investors can be easy prey for advisers who know that all they have to do is recommend whatever has been performing well lately. It's not hard to lure many investors by assuring them that they too can get in on the gravy train.

   What you've just read is a recipe for being taken advantage of while you look in the rear-view mirror.

   Protect yourself: Don't chase recent performance.

4. **Giving away too much money:** I'm all in favor of generosity. But investors who don't have a good plan can easily fail to understand how much they should be spending. Too often I've seen retirees being overly generous to charities and family members with money that they may need for themselves.

   Protect yourself: Have a plan and a budget; treat giving as if it were spending.

5. **Taking too much out of retirement accounts:** I've written extensively and repeatedly about withdrawals. One of the biggest lessons I've learned is that high withdrawal rates almost always put retirees at risk of running out of money.

   Protect yourself: Educate yourself about withdrawals and withdrawal strategies.

Financial Risks

Some risks of investing are external and beyond our control. You've probably seen lists like this before, and I don't want to belabor them, but here are four financial risks you should pay attention to:

1. **Market risk:** Your investments may decline in value because of a falling stock market (equity risk), a decline in bond prices after an increase in interest rates or (if you own international investments) a change in exchange rates.

   Protect yourself: Accept the fact that such changes are simply normal and inevitable; diversify your equity investments among asset classes with histories of outperforming the S&P 500 index over the long haul (see the reference to my previous column at the end of this article).

2. **Bad luck:** If you make a big investment right before a bear market hits, you can lose a lot in a hurry. Though we hate to admit it, occasional stock-market losses of 50% are normal.

   The laws of mathematics are harsh. If your portfolio loses half its value, it takes a 100% gain to break even. This type of bad luck is especially hard to deal with right after you retire.

   Protect yourself: Make sure you have enough bond funds in your portfolio so you won't be likely to exceed the limit of your ability and willingness to tolerate losses.

3. **Good luck:** Ha! I bet you didn't expect to see that on

this list.

The danger with good luck is primarily psychological and behavioral. Here's how it can go:

- ◊ You make an investment in something risky, like one or two individual stocks.
- ◊ You quickly make a lot of money.
- ◊ You're happy.

Instead of recognizing good luck when you see it, you conclude that you are smart and you have figured out how to be successful at investing.

You act on this belief, and (inevitably) reality slaps you in the face.

Protect yourself: If necessary, keep doing this over and over until you finally learn the difference between good luck and your own brilliance.

4. **Fraud:** Outright fraud used to be a much bigger risk than it is today, with heavy regulation of mutual funds and brokerage houses. In some ways, mutual funds are more regulated than banks. But fraudsters are definitely out there, eager to take your money any way they can.

I have a friend in his 90s who lost more than $100,000 to mail-order fraud. He told me: "They all seemed so nice, and they were giving me a chance to make a lot of money with very little risk."

Protect yourself: If something seems too good to be true, don't put money into it until you know the answer to the following: If there's so much easy money to be made, why haven't the professionals snapped up all this opportunity for themselves?

A Parting Thought

To be a really successful investor, start by studying the relationship between risk and return.

I spent a lot of time doing that, and I concluded that the best route to long-term success lies in a broadly diversified portfolio of index funds that invest in asset classes with long histories (50 years or more) of providing reasonable returns with moderate risk of loss. (See my article, "Digging Deeper Into Diversification," in the September 2019 *AAII Journal*.)

That combination has rarely disappointed long-term investors. ■

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