Understanding Investment Risk

Do you consider yourself a risk taker?

In reality, we're all risk takers. Every action—whether something small like trying a new shade of lipstick or something major like choosing a spouse or deciding where to live—involves risk.

At the moment, the idea of financial risk might give you the jitters. With the beating many people took in the financial crisis, that's understandable.

But as life returns to something closer to normal, many of us—especially those who recently shifted to more conservative investments—will need to think about making sure there's enough risk in our strategy.

Why? Because higher risk, as long as it's balanced appropriately with more conservative investments, usually also means more growth potential. This, in turn, can mean a better chance of achieving goals and dreams for yourself and for your family.

Coming out of 2008 and 2009, it's easy to say, "I don't want to risk *any* of my money. If there's a chance of losing anything, I'm not interested."

But being too conservative can lead to disappointment. Unless you're content with growth only modestly above the inflation rate, some risk is essential. The key is to determine how much to invest in higher-risk categories. Lower-risk investments tend to produce returns that, for most people, won't meet financial goals.

For example, if you had money in stocks before the crisis of 2008, cashed all of it out after the market tanked, and made no new stock investments in 2009, you missed out on one of the strongest annual percentage gains of the past 10 years.

Why is risk important? Because when you're aiming for above-average performance, above-average risk almost always goes with the territory. It's as true in business as it is in other areas of life. If an Olympic skier or a concert violinist never takes chances, is she likely to achieve a world-class performance? Probably not.

In business, high growth investments usually reflect companies that are taking the chances necessary to innovate and outperform competitors. They need to approach risk intelligently—recklessness in business doesn't pay. But calculated, balanced risk often does.

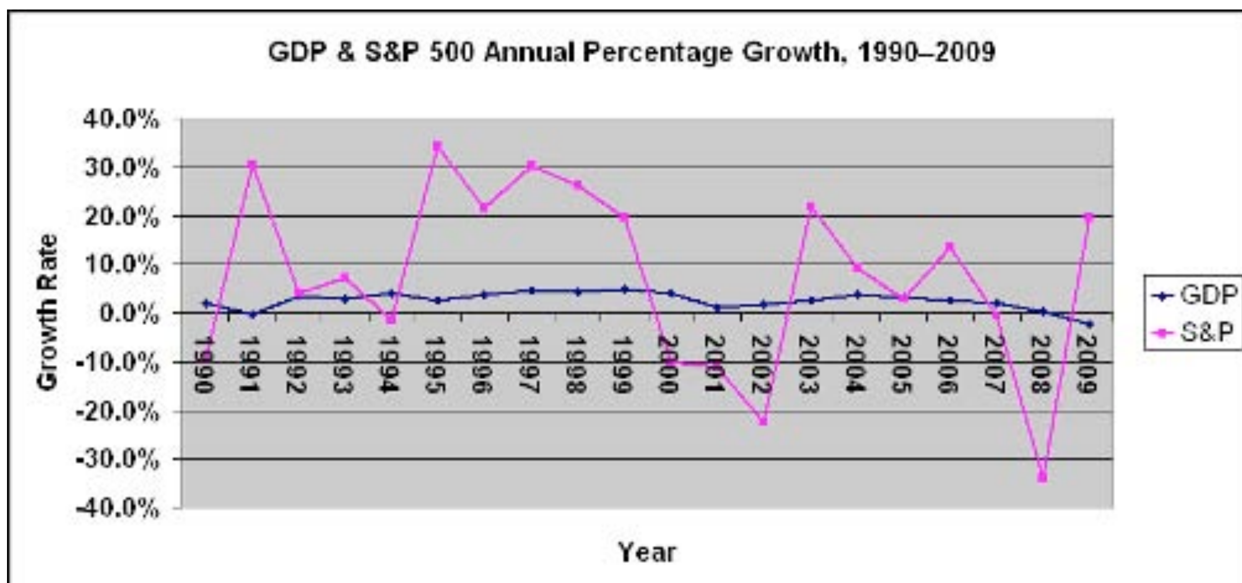
The path of business risk takers is seldom free of twists and turns. The normal sequence includes setbacks as well as triumphs as businesses develop good ideas, run into obstacles, and find ways to overcome them. That's why business risk-takers can experience painful periods of loss as well as outstanding gains. And it's also why higher-risk investments can fluctuate so much.

To understand what this means to your investments, let's look at some big-picture data. When you examine the entire U.S. economy, you see the full range of what's happening in business—companies that are doing splendidly, companies that are achieving just "middling" performance, and companies performing poorly or failing.

That's why Real Gross Domestic Product, a measure of all goods and services produced in the U.S. each year, tends to grow at a rate that looks rather modest—an average of 2.6 percent annually over the 20 years from 1990 through 2009. This is almost certainly less than the growth you want for your investments. In effect, GDP averages together the different levels of risk and performance—low, average, and high—of businesses throughout the country, resulting in a big picture of overall growth that looks … well, … average.

But let's look at another measure. The S&P 500 indexes stock prices of the 500 most widely held public companies traded on the New York Stock Exchange. The average annual growth rate of the S&P 500 from 1990 through 2009 was 7.6 percent—nearly three times faster than the entire U.S. economy as measured by Real GDP. Why? The growth reflects the risk many of these companies are taking to perform exceptionally. In any given year, some of these companies succeed in achieving outstanding performance, and some fail. But on average, companies taking the risks necessary to innovate grow at an above-average long-term rate.

However, in some years most of these companies miss the mark. That's why the growth rate of the S&P 500 has varied so much during the 20-year period, ranging from a high of over 34 percent in 1995 to a 34 percent decline in 2008. The volatility illustrates that higher average growth comes with a higher risk of decline in any given year.



SOURCE: Data on Real GDP annual growth rates are from the U.S. Bureau of Economic Analysis. S&P 500 growth rates were calculated using data from Yahoo! Finance, comparing the values of the S&P 500 index at the close of the last trading session of each year.

To generalize, returns on higher-risk investments, such as stock mutual funds, tend to look more like the S&P 500—more variable, but with stronger long-term growth. Lower-risk investments like bond and money market funds tend to grow more like GDP—slow, steady, and average.

Risk can be intimidating. But without it, it's difficult to succeed. If you retreat from risk entirely and invest all of your money conservatively, you may not earn enough to achieve your goals.

The solution is *managed* risk. When it comes to finance, whether or not you're a "risk taker" shouldn't be a matter of personality. Instead, it should be a question of *how much* risk your portfolio should include. The answer should be based on an objective evaluation of your overall goals, resources, and life situation.

An experienced financial advisor can help considerably. Factors to consider include your:

- Age
- Family status—married or single, with or without dependents
- Income and its expected rate of increase
- Goals—retirement, college, home purchase, etc.—and when you want to reach them
- Total financial situation, including the value of all assets, such as cash savings and home equity, and of other investments like retirement portfolios

Generally speaking, the longer your investment timeline, the more risk you can afford. But there are other considerations. For instance, if you already have a well-funded retirement portfolio with balanced risk, you may be able to afford more risk in supplemental investments.

After determining an appropriate risk level, managing your portfolio strategically can help you make the most of your plan. When you buy in by investing a specific amount at regular intervals (dollar cost averaging), you smooth the effect of price fluctuations. And by regularly doing what investment professionals call *rebalancing* your portfolio you can build into your strategy the old principle of "buy low, sell high."

For instance, your advisor might suggest 60 percent in an S&P 500 mutual fund and 40 percent in a low-risk bond fund. After a landmark quarter for the market, you find that your stock fund's value has grown to 65 percent of your portfolio. By selling enough shares to bring your stock investment back to 60 percent, and investing the cash back into bonds, you have captured some profit, while returning to the recommended risk level.

The reverse also holds true. If a bear-market year lowers your stock investment to 55 percent, you would cash out some of your bond funds and buy more stocks. The instinctive reaction might be to do the opposite—pull out of stocks entirely, fearing that they have become too risky. But look at the chart again. Many years of negative S&P 500 growth were followed by significant growth. When you buy stock in a down market, you're purchasing it at a reduced price (buying low), setting the stage for more profit once the market rises again (selling high).

These are simple examples. Real-world situations can be complex. Few of us have time to learn everything necessary to manage the process well. Every investor's situation is different. But good financial advisors, such as the Investment and Trust Management partners available to York Traditions Bank customers, will have the knowledge, skill, and experience to help you manage investment risk in a way that matches your unique circumstances.