Risk: Are You Thinking About It Correctly?
By Matthew B. Anderson, CFP®, CPWA®, CLU®, Senior Vice President and Financial Planner

It’s March Madness baby! The time of year when millions of people around the country attempt to come up with the perfect NCAA Tournament bracket. There has been much written on the subject of “bracketology”—the strategy of how to pick the winning teams in a tournament bracket. Of all the strategies, it is usually understood that there will be some upsets where a lower seeded team will beat a higher seeded team. The hard part is picking which lower seeded team will be the one to prevail. Is it worth the risk to try and pick the one or two upsets that might occur, especially when there has never been a seed lower than 8 that has won the tournament? Why not just stick with picking the favorites? Or is picking only the favorites also a risky strategy? In the end, it really doesn’t matter, as the odds of a perfect NCAA Tournament bracket are 1 in 9.2 quintillion! Luckily, investing to meet your financial goals has a much greater chance of success. However, being successful means understanding and managing risk.

Question: What is more risky, a 100% stock portfolio or a 100% cash portfolio? At first glance almost everyone might answer that a 100% cash portfolio is less risky. However, that answer would be wrong. The correct answer is that the question is unanswerable. We need to know more information. This simple question can teach us a lot about investing concepts. So what information do we need to know in order to answer the question?

What is the time horizon for achieving the desired objective?

If you have a definite investment objective in 1-2 years then of course a 100% stock portfolio would be the riskier investment. This is because over short periods of time the risk of significant loss in the stock market is substantial. In fact, since 1926 the worst one year return for the S&P 500 was -43%. This would be very hard to recover from. Examples of this type of savings objective would be the purchase of a home in 1-2 years or a college investment account for a student entering school in 1-2 years. However, what if your desired objective is well into the future? For example, you are saving for retirement in 20 years. In this instance, a 100% cash portfolio would be the riskier investment. You may not lose money on paper, however inflation will eat away at the purchasing power of your savings and the return on cash probably won’t be enough to grow the nest egg needed for retirement. Over longer investment time horizons, the risk of losing money decreases. In fact, the worst 20 year annualized return for the S&P 500 is 3%. This doesn’t mean the ride will be smooth (remember the 1 year loss potential above). You will need to stay focused on the long term and ride through the ups and downs of the market. O.K., so the longer the time horizon for investing, the lower the risk of a 100% stock portfolio. Is that correct? The answer is maybe. We need to know more.

What is the investor’s tolerance for market volatility?

We often hear return numbers thrown around for stock market indices. However, is a stock market index really a good proxy for how the average investor performs? There is a difference between investment returns and investor returns. According to Dalbar, Inc “Quantitative Analysis of Investor Behavior, Advisor Edition.” April 2015, the average equity investor had an annual return of 5.2% over the 20 year period ending December 2014. This compares to the S&P 500 annual return of 9.9% over the same time period. The difference in return is substantial and illustrates the damage that can be done through poor decision making. Most of the poor decisions occur during times of market turmoil. Over a 20 year time horizon, markets can experience large drops in value. If you overestimate your tolerance to withstand these types
of drops, you may make an emotional decision to sell at exactly the wrong time. And when you sell, you
lock in the loss of value. Not only do you lock in loss but often investors will stay in cash until things settle
down. However, by the time things settle down, the market has probably gone up significantly. For
example, for the 10-year period ending 12/31/15, an investment of $10,000 in the S&P 500 would have
grown to $20,242. However, if you missed the best 1 month period you would only have $18,248. Missing the best 12 month period would have left you with $8,413. Managing emotions during times of
market turbulence is extremely important if you are going to be a successful long term investor. Investors who cannot accept large short term swings in the value of their portfolio should not be heavily
invested in equities. O.K., so as long as one can accept the ups and downs and has a long time horizon,
a 100% stock portfolio is less risky. Not quite. We still need to know more.

What is the makeup of the stock portfolio?

There are two different types of investment risk--Diversifiable and Undiversifiable Risk. Undiversifiable
Risk is also known as Market Risk. This is the risk that cannot be mitigated through diversification. The
financial crisis of 2008/2009 is a perfect example of Undiversifiable Risk. If you were invested anywhere
in the stock market during this period of time there was no place to hide. Everyone suffered significant
decreases in the value of their equity portfolio. As investors, we should be most concerned with
Diversifiable Risk. This risk affects a very specific group or an individual stock/company and can be
mitigated through proper diversification. A 100% stock position in one company involves a significant
amount of risk. In fact, it involves the potential for a loss of one’s entire investment if the company goes
out of business. As you add stock in more companies to a portfolio the risk of total loss decreases;
especially if the companies are in different industries.

So while you are balancing the risks of different strategies for attacking your NCAA Tournament brackets,
also take some time to think through the risks in your investment portfolio. Think about what you are
investing to achieve and the time horizon for doing so. Make sure your portfolio is allocated in a manner
that will allow you to focus on your objectives without making emotional investment decisions. Lastly,
ensure that your portfolio is diversified in order to mitigate concentrated equity risk.

If you are unsure where to start. The Wise Investor Group can help you determine what strategies are
suitable for your needs with a personalized financial plan and customized investment portfolio designed to
help to achieve your specific investment goals.

Matthew B. Anderson, CFP®, CPWA®, CLU®
Senior Vice President
Financial Planner
The Wise Investor Group
Robert W. Baird & Co.
866-758-9473

With 17 years of experience in the investment industry, Matt provides financial planning services to clients,
specializing in annuity, insurance and strategic estate planning. He is a CERTIFIED FINANCIAL PLANNER
™ practitioner and holds the Chartered Financial Consultant ® and Chartered Life Underwriter®
designations. Matt received his bachelor’s degree in business and economics from Lehigh University.

Certified Financial Planner Board of Standards Inc. owns the certification marks CFP®, CERTIFIED FINANCIAL PLANNER™ and federally registered CFP
(with flame design) in the U.S., which it awards to individuals who successfully complete CFP Boards initial and ongoing certification requirements."