

The Many Faces of Risk, Part 1

- ▶ Financial risk can be measured in different ways, depending on the circumstances.
- ▶ As this article indicates, investment risk can be measured as volatility (the range of possible returns) or the risk of loss (ending with less than you began with).
- ▶ However, we find that the real financial risk that most individuals face is the risk of not meeting their financial goals, whether it is funding their retirement or their children's college expenses.
- ▶ Often those who attempt to avoid investment risk also fall short of their financial goals.

There is no question that risk carries a negative connotation for investors. But the simple fact about risk is that it's ever-present. There is more to risk than market volatility, and trying to avoid risk is like trying to avoid the oxygen in the room. You might think you're avoiding it by sticking with safer investments, such as bonds. But when you make moves like this, you're usually just swapping one kind of risk for another. In this case, you may have reduced short-term volatility risk, but you likely increased long-term shortfall risk: With a heavy emphasis on lower-yielding "safe" investments, your portfolio may not grow enough to meet your retirement needs or overcome inflation over the long term.

On the flip side, we may also mistake an upward trend in the market for the absence of risk. A strong performance streak doesn't mean there was no risk. It just means that risk didn't bite hard during that time period. Don't confuse being lucky with being risk-proof.

So, we can't avoid risk. But neither should we be oblivious to it. What we need to do is understand the risks we're taking, and remember risk's traveling companion: reward. This keys in on an important point: Risk isn't inherently bad. When you take risk, you can have good outcomes, too. Risks should have related and commensurate potential rewards. We invest in the market not because risk is bad and we expect to lose money, but because taking risk can be profitable. So, the question is not whether to take risk. Instead, it's what risks do you want to take, and how much?

Types of Risk

As suggested above, there is more than one kind of risk, and to manage risk well, you need to consider the different types. For instance, investing risk is not all (or even mostly) about the market's volatility (the Dow's daily ups and downs on Fed talk, China's latest data, or any number of global worries).

When thinking about investment risk, you need to consider company fundamentals (what will cause this firm to succeed or fail), because that will ultimately

drive the stock price over time. There is also price risk. Even if the company is poised for tremendous success, how much are you paying to own a piece of it? If you overpay, you can still lose money, because stocks tend to revert to their fair value over time, even if they occasionally become under- or overvalued.

You also have to consider your own shortfall risk. Conceivably, you're investing in the market to fund some future expense (for instance, college or retirement). If you take money out of the market, or move money from stocks to bonds, what does that mean for your long-term earning potential, given the types of returns bonds tend to produce over long periods of time? Remember, funding that future expense is your primary objective, not avoiding every little dip in the market along the way.

But instead of fundamental, price, and shortfall risk, we investors tend to focus on short-term volatility because that's the thing we see every day, in real time. It's the most apparent and seemingly uncontrollable risk. Make no mistake, volatility may reflect real changes in a company's fundamentals, and that can mean a real loss of money for you. But volatility is often just noise, reflecting worries that won't have any lasting or appreciable effect on a company's operations. In these cases, we shouldn't let volatility risk leave the realm of paper losses.

That's easier said than done, of course, especially during a market crisis or correction. But one way of getting around that is by considering another type of risk: liquidity risk. That's the risk that you can't sell an asset (or at least can't sell it for a reasonable price) when you need to sell it. The upshot: If you have a short-term need for cash, then have cash on hand. That allows you to ride through the volatility risk of your other assets.

The Many Faces of Risk, Part 2

The Risks You Do Take Are Manageable

The good news is, even if you have to take some short-term risks you'd rather not, you can take the edge off in a number of ways. Diversification among asset classes may reduce marketwide or so-called systematic risk. In 2008, the bond market held up just fine even though stocks uniformly fell on their face. Holding assets that move in different directions at the same time makes for a smoother ride overall and gives you more options should you need to liquidate a portion of your holdings for some reason.

You may also want to consider diversification within one asset class. Holding several stocks (as opposed to just one) from the same industry and other industries may reduce company-specific risk (such as product-launch failure) and sector-specific risk (such as e-books and e-mail taking a bite out of paper company profits). Another way to manage fundamental risk is to invest in companies that have sustainable competitive advantages.

Dollar-cost averaging, or putting your money to work in smaller chunks over time, may reduce that risk. It also happens to be the de facto way that most people end up investing—with a little bit of money coming out of every paycheck. Another way to potentially reduce price risk is requiring a margin of safety before buying. All else equal, if you like a stock at \$50 per share, you should love it at \$30. Buying at a discount means you have room for error in your analysis, a buffer in case of an unforeseen complication, or the chance for extra return if everything goes as planned.

Don't Let Risk Take You

Unlike the familiar risk of going to work for an immediate reward (a paycheck), when it comes to investing, the reward is typically delayed, while the perceived risk (specifically market volatility) is immediate. Because of short-term market gyrations, investors may also feel that they can't control or moderate their investment risk. So, there is a disconnect between perceived high and uncontrollable present risk on one side, and an uncertain future reward on the other. That just doesn't sound like a

good trade-off.

But that story is not complete. You also have to think about shortfall risk and the opportunity cost of not investing (in other words, the money you could have made over time but didn't because you weren't invested). You have to think about the cost of inaction, because not taking any action is potentially risky, too, just in a different way.

When you look at it this way, you should realize you can't avoid risk. So, don't let risk just happen to you. Since you'll end up taking risk in one form or another, you might as well take control, and take smart risks. Take risks in a way that you choose, in a form that you manage to reach your goals—knowing the trade-offs and the consequences and the rewards.

There is no guarantee that diversification, asset allocation and dollar-cost averaging will protect against market risk. These investment strategies do not ensure a profit or protect against loss in a declining market. In addition, since investing by dollar-cost averaging involves continuous investment in securities regardless of fluctuating prices, investors should consider their financial ability to continue purchases through periods of both low and high price levels.

Returns and principal invested in stocks are not guaranteed, and stocks have been more volatile than bonds. Investing does not ensure a profitable outcome and always involves risk of loss.

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