COMPASS WATCH

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INVESTMENT MISTAKE #2: IGNORING RISK

Our spring 2005 Compass Watch (Volume 17, Number 1) was the first in a series entitled, "Investment Mistakes." This article* is closely related and seems timely in view of the many investors today who seem to be ignoring risk while pouring money into more speculative energy stocks, hedge funds, etc.

Risk is among the most commonly used and abused terms in the investment field. But what, precisely, is meant by "risk"? Although volumes have been written on the subject, here are a few basic concepts which may help investors begin to think more comprehensively and analytically about this fundamental investment concept.

- Principal Loss – This is perhaps the most important aspect of risk: "What is the likelihood I will lose all/part of my money if I invest in this? Moreover, if a loss occurs, is it likely to be permanent (realized) or temporary (unrealized)?"
- Fluctuation in Value – Very frequently, when investors speak of risk, this is what they mean. Stocks seem "risky" because they fluctuate in value. So do family homes, but since they are not quoted daily in the newspaper, they do not seem volatile. Far too much attention is given to this aspect of risk. After all, it is desirable that investments such as common stocks and bonds fluctuate in price - - presumably more up than down.
- Income Loss – Investors buying 3-month U.S. Treasury bills (or bank C.D.'s or money-market funds) at the beginning of 2001 may have been pleased with the 6% annual yields available at that time. However, if they continued investing in this way, their investments would have yielded less than 1% annually just three years later, as short-term interest rates plummeted. Most income investors, especially retirees, need to be sure their income stream is rising, or is at least somewhat predictable.
- Opportunity Loss – This form of risk is felt when you are invested in the "wrong" asset. For example, market timers often feel this when they are parked in money-market funds while the bond or stock markets roar ahead.
- Purchasing Power Loss – Inflation and taxes are deadly enemies if you are trying to maintain purchasing power. For this reason, it is actually possible to be "too cautious" with your investments. Preserving principal is important, but if the principal you preserve won't buy much in retirement, you will eventually suffer from this type of risk. Certain kinds of investments are better or worse at preserving purchasing power, and a good financial advisor knows what they are.
- Personal Risks – Often overlooked are personal factors which could jeopardize an individual's likelihood of investment success. These factors may include job and marital stability, health, major new financial commitments (new house, care of elderly parents, etc.) among others.
- Regulatory Risks – Changes in tax policy and the regulatory environment have had significant impact on the capital markets of late. Rising taxes, for example, make municipal bonds relatively more valuable than taxable bonds for many investors, while political pressures have helped erase up to half the market value of some pharmaceutical companies.
- Failing to Achieve Expected Results – This major risk for a money manager/advisor results from a failure to understand the client sufficiently. A money manager's job is not simply to strive for the highest possible return. Instead, a good money manager delivers competitive long-term returns consistent with the client's risk profile and objectives and with the manager's stated investment style. Such an understanding of the client should have been developed in writing long before securities are first purchased in the portfolio, and this investment policy statement should be reviewed regularly at subsequent client meetings.

Next time someone tells you an investment is "risky"; ask them what kind of risk they have in mind. They will be impressed, and you just might help them avoid a costly mistake.

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* An updated version of the Compass Watch of Summer 1993 (Volume 5, Number 2)

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