What's the risk?

Identifying and dealing with probable adverse events

By: Troy Sapp, CFP®
Commencement Financial Planning LLC

Risk is a fact of life. We are constantly surrounded by it, but we do things in our daily lives to reduce the likelihood of a risk causing us harm. We look both ways before crossing the street. We purchase home and auto insurance. We get regular check-ups with our doctor. We do these things not because something bad *will* happen if we don't, but because something bad *might* happen.

Managing your investment portfolio's risk is no different, but in order to deal with risks that might cause you financial harm, you must first identify exactly what the risks are. As you can guess, the risks are indeed plentiful. The exceptionally good news is all of the potentially harmful risks can be minimized but one!

The main risks *all* investors face are:

- Interest rate risk
- Reinvestment risk
- Default risk
- Inflation risk
- Liquidity risk
- Specific risk
- Market risk
- Ourselves

The following is a discussion of these risks and what investors can do to hedge against potentially harmful outcomes which they can create.

Interest rate risk

Interest rate risk is the risk that prevailing interest rates will rise above the rate an investor is earning on his income producing assets. This causes the value of the investor's income producing asset to drop.

If, for example, an investor owns a $10,000 long term bond yielding 5% annually. If prevailing interest rates for similar bonds increase to 10%, the value of the investor's bond would *drop* by approximately 50%. This is because bond buyers would not purchase the investor's bond unless it provided the same return they could get shopping elsewhere.

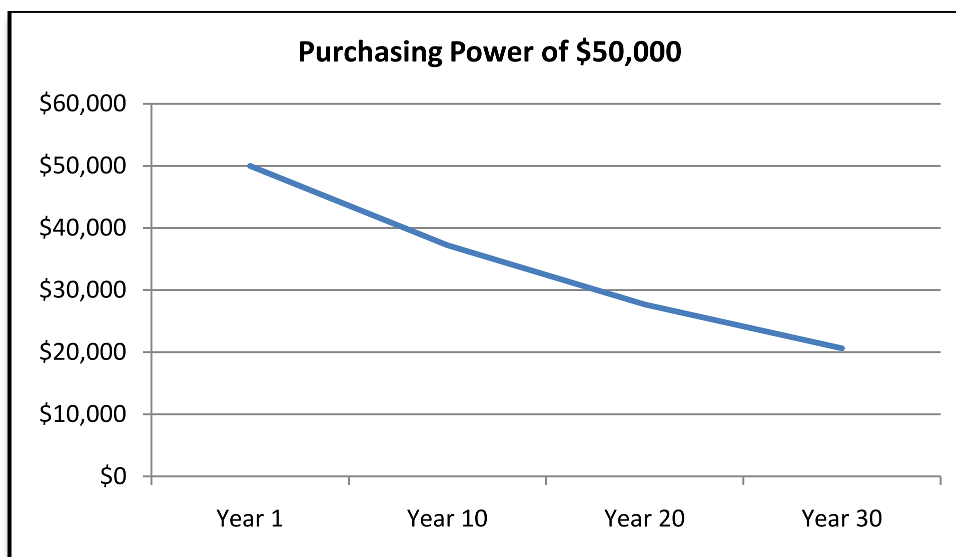
Most people view bonds as safe, but even high quality bonds will decrease in value as prevailing interest rates rise. Interest rate risk can be reduced by purchasing bonds with relatively low duration.

Reinvestment Risk
Reinvestment risk is the risk that income and/or principal received from income producing assets cannot be reinvested at a similar yield as those assets are or were providing. This occurs when prevailing interest rates fall in relation to those of an investor's current or called holdings.

Unlike interest rate risk, reinvestment risk most dramatically affects bonds with *low* duration as well as those than can be called by the issuer. In order to hedge against this risk an investor should increase the duration of his bond portfolio (but not so much as to overly expose the portfolio to undue interest rate risk) and diversify broadly.

Default risk
Default risk is the risk that an issuer of a bond will not repay interest and/or principal as promised. Bonds issued by the United States government (Treasury bonds) are considered to have no risk of default, but they also tend to pay the lowest interest rate. Properly complementing Treasury bonds with a well diversified portfolio of both high and low quality non-Treasury bonds helps to maximize returns while lowering the risk of default.

Inflation risk
Inflation risk, perhaps the most insidious of all risks, is one of the most likely and potentially damaging to the long term investor. Over long periods of time, even moderate inflation takes its toll by continually chipping away at purchasing power. This is the effect of 3% inflation on purchasing power over 30 years:



By year 30, purchasing power was reduced by 59% assuming a modest 3% inflation rate! Slowly but surely inflation always has and always will eat away at purchasing power. A long term investor that does not take action to reduce this highly probable risk is setting himself up for disaster.

Bonds are generally crushed by inflation, but bonds known as Treasury Inflation Protected Securities (TIPS) are the exception. Though the use of TIPS should be limited, they can be used effectively as an inflation hedge.

Stocks also tend to hold up well against inflation, but they are also quite volatile in the short term. It is critical the investor properly weigh both his short and long term goals to determine the amount of his portfolio to allocate toward stocks. This exercise will create an inflation hedge while appropriately limiting anticipated short term volatility according to the investor's goals.

Precious metals and other commodities also tend to hold up well during inflationary times, but these do not come without their own unique risks. Before adding commodities to a portfolio an investor needs to carefully examine and fully understand how and why they are expected to improve the risk/reward profile of the portfolio as a whole.

Liquidity risk

Liquidity risk is the risk an investor will not be able to sell an investment when he desires or requires cash. This risk is most often associated with investment in businesses, real estate, and tangible items such as machinery and collectibles, but also can occur with other investments that would otherwise be anticipated to *not* have liquidity risk.

Such was the case with Auction Rate Securities (ARS). During 2008, the four largest broker-dealers (Citigroup, UBS AG, Merrill Lynch, and Morgan Stanley) who made a market in ARS failed to be the buyers of last resort for these investments when there were no longer other investors wanting to buy them. The result was catastrophic for the clients of the four large brokerages. Not only were their clients not able to liquidate their ARS positions, but the value of ARS suddenly evaporated.

Investors should make sure the market for an investment product is broad and deep. Investors should also be completely aware of their time horizon and the anticipated time needed to maximize the benefit of various investment alternatives as forced liquidation should be avoided.

Specific risk

Specific risk is the risk that any one investment will underperform or fail altogether. Specific risk that can be diversified away is also the only risk for which investors are not compensated!! If you are not compensated for taking on risk there is simply no reason to bear it.

Specific risk can be dramatically reduced by purchasing many different stocks and bonds. Most studies have found that a single investment representing more than 5% of a portfolio exposes that portfolio to an unacceptable level of specific risk.

Market risk
Market risk is the one risk we can do very little about. It is the risk that an entire market drops in value. When this occurs there are few places to hide.

What we do know is bonds tend to be less volatile than stocks. There are also a great number of alternatives for even the smallest of portfolios to gain exposure to various investments around the globe.

An investor's risk tolerance will determine the proper mix of his targeted bond and stock allocations. To fulfill these allocations the investor should then adopt sub-allocation targets anticipated to provide the maximum level of return for the amount of risk the investor is able to tolerate.

Diversifying globally should help to alleviate market risk, but in an Armageddon scenario no one would be spared. Fortunately, this risk is extremely small and since we can do little about it we should not waste our energy worrying about it beyond getting the bond/stock mix correct, then diversifying globally.

Ourselves
Perhaps the greatest risk of all stares back at us in the mirror!

Most of us have simply not taken the time to develop and implement a well thought out investment strategy. Still others who have had an investment strategy simply were not comfortable enough to stick with it when they needed most: During times of false overconfidence or panic.

Failing to develop a well thought out investment strategy that you understand and are comfortable with is the most critical financial matter in your life. Without such a strategy financial futures are left largely to chance.

Develop, understand, and be comfortable with a prudent investment strategy you can stand by during good times and bad. Your future depends on it!

In later commentary I will discuss the importance of developing and implementing a well thought out Investment Policy Statement.