

Not Balancing Risk and Return

Top Four Financial Mistakes

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Every investment carries some sort of risk. Risk is measured by the uncertainty of a specific future return. Some of it might be the loss of principal or perhaps the loss of earning power just through inflation. Exactly how can you measure this uncertainty?

Luckily, all the information necessary to measure risk/uncertainty is available. If you have a large enough group of investments in a portfolio, you can describe risk using the portfolio volatility – that is, the change in its rate of return from time period to time period. The time period can vary, so risk and volatility are concepts that have a time element associated with them. For example, in the short-term, a home purchase might be risky if the purchaser has to move out of the house soon after purchase. It's quite possible the price of homes could drop, leaving the purchase with negative equity. This happened in the late 1980s and early 1990s, causing many first time purchasers to walk away from their homes because they could not sell them for enough money to cover the mortgage balances. Over a long period of time, say twenty years, the risk of losing money is much lower.

People generally talk about the stock market as if it's some kind of big unified event. That's now what's going on, however. When you read about the market indexes going up and down, what you're really seeing is a combination of the individual returns of a lot of different equities or stocks and bonds going up and down. For convenience, indexes have been developed as one number to simplify reporting. With convenience comes over-simplification, and with over-simplification comes a problem: the single number masks the individual actions of the underlying stocks bonds or funds. The underlying stocks or bonds vary much more on an individual basis. When combined with other securities that are behaving differently, the many individual swings tend to cancel each other out. As a result, putting many different investments in one portfolio can create diversification, which will dampen and reduce volatility.

Notice we said different investments. Here's where the average investor makes the risk/return mistake. Simply investing in what appears to be different stocks and bonds in order to diversify to reduce risk could be a huge mistake! Owning several investments, whatever they might be, does not by itself reduce risk and volatility.

In order to reduce risk and to have a good return with lower risk, you have to properly choose types or categories of investments that don't have the same investment characteristics. In other words, they don't behave the same. For example, if you buy three oil companies and three petrochemical manufacturers, you really haven't diversified even though you now have six different investments. Why? They're all going to behave similarly under different economic conditions because they're in the same highly related industries. So, how can an investor properly diversify to reduce risk?

What you must consider for effective diversification are different behaving investments. For example, different investments could be a copper mine and a pecan farm. These two businesses have little in common and will behave differently under varying economic conditions. Other investment pairings would be a small foreign company and a large domestic company, or mutual funds composed only of small foreign companies and large domestic companies. What you must do is construct a portfolio of different stocks and bonds whose investment behavior will reduce the volatility because their investment behavior is not correlated. If they are correlated, they act similarly under changing economic conditions. Non-correlated investments don't behave the same during changing economic conditions.

This mistake is made when amateur investors do not properly diversify, even though they have many seemingly different individual investments in their portfolio. Why not? They don't understand the correlation between investments. As a result, they do not understand how risky or volatile their portfolios really are relative to the return they're getting.