RISK

HOW MUCH RISK ARE YOU WILLING TO TAKE IN THE MARKET PLACE?

The problem with risk is that it is impossible to measure. Trying to mathematically calculate what the odds are that you could lose money is a completely impossible task on an objective basis.

Oh I know that lots of people have attempted it and there are lots of methods out there to help mathematically determine your risk level. However, each method contains some faults and assumptions that basically will show the method to be unreliable from a financial planning perspective.

Why? Because all of the data used is based on past historical data which is never representative of current economic conditions. Showing the risk of a particular investment, for example, stocks cannot be accurately done unless the same conditions that exist today, existed throughout the time period of data being used. To say that the stock market averages 11% a year, does not mean you will get 11% this year. After all, that average was made in bull markets, and bear markets, and flat markets. Which one are we in now?

Even if you knew, there are different types of bull and bear markets. And there are different conditions that caused these different bull and bear markets. So the risk that stocks may go down is valid. But it may not be as valid for 2005 as it was in 2004.

At times, any investment carries more or less risk than at other times. Bonds, for example, are generally considered to be less risky than stocks. In the long run, that is true. But if you aren’t a long run investor, then it is not necessarily true. In any given year, bonds may be less risky than stocks for that year. Again generally speaking, if interest rates are rising, then bonds are going down in value and stocks are likely to go up. In this environment, bonds would be considered more risky than stocks.

How much more risky? Again that is hard to quantify. In my mind, I always think I could come up with a number, but I can never justify that number with any hard evidence. It just isn’t possible due to the number of economic factors that are involved and the fact that these same economic factors have not occurred enough times in history to the same degree and level that they are expected to or are occurring now.

Therefore, if anyone tells you that one investment is less risky than another, remember it is only true if you are investing for the same period time that their research was conducted over and again only if the same economic conditions presented itself for the same time period.

Are bonds less risky than stocks? At times, and at times they are not. Is real estate more risky than bonds? At times, and at times it is not. So what is an investor to do?

First of all you must analyze economic conditions and then make your best guesstimate. Are you qualified to do that? Do you have the data, the analysis skills and the experience needed to make an accurate guess? Needless to say it can be a daunting task and you can pay dearly for any mistakes. That’s why it pays to get professional help. However, you must get the right kind of help. If your advisor is one that thinks you can quantify risk or one that thinks certain investments are more risky than others, I would keep looking. And unfortunately that probably represents that vast majority of financial advisors. However, your search is critical as this component of investing is one third of the investment formula and is just as important, if not more so, than performance.

There are three factors to any investment. How much you can make. How much you can lose. And the odds of success or failure. And it is this third component that is so difficult to measure or determine. Yet it is an equally important part of the successful investing formula as the other two are. Ignore it or fail to do a good job on it and you will probably never have successful investments.