Capital Management Inc.

Look Risk in the Face and It Will Cease to Trouble You

Saturday's With Jim

By Jim Pursley
President and CIO, Gaia Capital Management, Inc.
www.gaiacapital.com
6/3/17

Dear Friends,

John Bogle, the founder of Vanguard, says, "Invest you must." Why? Because if you don't you are not making the best use of your resources. What about the risk of investing? In his June 1, 2017 blog, "Reframing the Concept of Risk," Ben Carlson of *A Wealth of Common Sense* noted, "It's not only framing but our perception of risk that matters."

An Element of Risk

Carlson notes that in the aftermath of 911, travelers took to their cars, eschewing air travel because of the widely publicized way passengers in the hijacked planes died. But in choosing the independence of their own decision making, 1,600 additional people in the U.S. may have died, for auto travel is more dangerous than air travel when all is considered. Travelers perceived air travel to be riskier than car travel because of a recent incident, not because of the long-term safety statistics. An equivalent exchange of risks occurs when a well thought out portfolio is sold at a considerable loss because the investor "can't take it anymore." The investor exchanges market risk (up and down market movement of account balances with constant price changes) for the perceived safety of cash. However, the loss taken is frozen into the account's performance. There will be a permanent loss if the account is never reinvested again in stocks and bonds – or if reentry occurs when things look "safe" again creating the risk that the investor's plans for the money will not be realized.

It's Risk That Makes Gain Possible

There is nothing risk free. Putting away more than you need for emergencies in a bank account exposes you to the risk that you won't gain enough to meet future needs, even if the latter are uncertain or undefined. If you think of risk as the uncertainty of getting any or all of what you expect, you have a negative view of risk. A positive view of risk would embrace risk as a benefactor. It's in the eye of the beholder, as they say. As the turtle cannot advance without exposing his head, so must you take measured risks to advance yourself in society, in the family and in the financial markets. Are we giving the impression, though, that investing's reward is not worth the degree of risk you might prudently take? No. There is a point where the reward is some factor greater than the perceived risk – and you take it. That point is different for everyone and is also variable as one's mental frame changes. Those who would not have touched a stock in 1994 were clicking mouse buttons on the riskiest of them all in 1998 and 1999. The herd instinct prompted many to take risks far above their normal comfort levels – and precisely at the wrong time, too.

Dotting i's And Crossing t's About Risk

We are fond of saying that stocks outperform bonds about 2:1 over meaningful periods – 30 years or more. But you can't spend all of your 9.5% return (historical average annual return since 1900). Why not? Because if inflation is 2.9% a year (117 year average) you will only get to spend 6.6% (9.5%-2.9%). Your money loses purchasing power as time passes. Bonds, with their 4.9% long-term return average, gained only 1.9% (4.9%-3%) a year in purchasing power while stocks were gaining 6.6%. It takes 36 years for a 2% return to double your capital while a 6.6% return doubles it in 11 years. The math above suggests that the reward for investing in stocks is hugely greater than that of investing solely in bonds the longer the investment is held. An investor with a large bond portfolio might feel safe, but each year the bond portfolio falls farther and farther behind the stock portfolio.

Fortunately, stocks and bonds can be combined to calibrate risk/return as needs and tolerances indicate.

So what?

Crafting an all-weather long-term investment portfolio is not as simple as it might seem from today's post, but you are truly looking risk in the face when we formulate a portfolio that balances your needs and tolerances for downside risk. The modulation of risk to fit your tolerance is called risk management and, without a doubt, is the cornerstone of an effective investing program.

We are grateful that you chose us to facilitate your financial journey. Thank you for investing with us.