



Corporate Marketing — Periodicals Division

MAKING VOLATILITY WORK FOR YOU — WHAT IS RISK AND HOW TO USE IT

Risk

(risk) n. 1. the quantifiable likelihood of loss of less-than-expected returns 2. The possibility of suffering harm or loss; danger 3. The volatility of returns from an investment 4. A sharp, sudden loss

Stocks can make you a lot of money. But they can also lose you a lot of money. How can you create and preserve wealth in the face of market volatility. The answer: *Use it.*

Volatility

Volatility on the stock exchanges has become commonplace. Fortunes go as fast as they come. Investors have had to dust off the concept of risk and grapple with its meaning. For some, it's the straightforward fear of losing money, for others it's the fear of the loss's consequences, or losses relative to someone else's gain, or volatility—or perhaps most important, it's the chance you won't have the money you need when you need it.

No matter which definition resonates with you, they all boil down to one major concern: uncertainty. How can you reduce this uncertainty? How can you mute volatility, and minimize the risk that you won't have the money you need when you need it? Buy *using* a simple approach that puts market volatility to work for you: Portfolio Diversification.

Mastering Risk and Reward

To understand how this works, you need to get comfortable with two measuring rods of investing: risk and return. *Return* is the profit (or loss) on an investment as a percentage of the money originally invested. *Risk* is used to mean volatility, the amount by which the investment's return deviates over a given period from its long-term average.

Investments Are Exposed to a Variety of Risks

- 1) **Inflation Risk:** This is the first risk that any type of savings—even money in a piggybank—is exposed to. Inflation risk is the risk that future purchasing power will

be eroded. One defense against inflation risk is the use of short-term money market accounts in which the rate earned may reflect the current inflation rate.

- 2) **Market Risk:** This is the potential loss of actual dollars through a decline in market value; what makes an investment vehicle's value go up or down.
- 3) **Market Timing Risk:** This risk arises when accumulations are transferred from one fund to another, in anticipation of upward or downward swings. Sometimes this is used as an offensive strategy: An investor transfers funds into an area expected to produce impressive gains, which exceed those possible in other areas.
- 4) **Economic Risk:** Economic, social and political areas are interrelated. A social or political disruption in one part of the world can suddenly and unpredictably affect stock prices. The defense is to avoid using funds with specialized investments that focus on specific companies, industries, and even countries, and instead to diversify.
- 5) **Management Risk:** Another consideration is protection against management risk—the fact that a change in portfolio managers introduces a new unknown. This is especially true if the past performance of a fund was based primarily on a particular person rather than on a policy of the company. This is an important consideration because the accumulations in your funds for retirement will probably remain in these investment funds over an extended period, longer probably than a single fund manager's tenure.

Using Diversification

Diversification is a tactic that spreads exposure over a range of investments. The theory is that the probability of simultaneous loss in all these investment areas is less likely than a loss in any one of them. Just as the type and degree of risk vary, so do the type and degree of diversification.

Some investment advisors suggest spreading assets across different funds, the idea being to have the advantage of the cumulative expertise of several different fund managers. The downside of this technique is twofold. The first is that the more funds and families of funds you use, the more administrative detail you must attend to. The second is that you may simply increase your interest in the same stock or bond—only through different portfolios. An easier way to diversify is simply to use one broadly based fund.

Simply investing in a *fund*—a combination of investment vehicles (or asset classes) rather than in single issues of stocks or bonds is already a diversification strategy. The fund will be invested in a number of different stock or bond issues—far more than you, as an individual

investor may be able to afford to analyze. If there is a problem with one stock or bond, the collective performance of the entire portfolio might neutralize some of the negative effect.

Another View of Risk

Looking at risk as the chance of a “sharp, sudden loss” is an apt working definition of risk if you expect to draw on your capital next month or next year. But if you invest for the long term—as most people do—your risk is the *chance your returns will be too low to meet your future needs*. Or simply, the *chance that you won’t have the money you need when you need it!*

Risk/Reward Profile of Three Most Popular Kinds of Financial Investments—1961-2000 (Annualized)

Asset Class	Return	Volatility
Stocks ^a	11.9%	14.8%
Bonds ^a	7.4	5.7
Cash Equivalents ^b	6.2	0.7

^a We use the S&P 500 Index as the broadest representative of stocks as an asset class. Within the huge bond market, the major choice an investor must make is between corporate and municipal bonds, also known as taxable and nontaxable, since munis are generally free of federal taxes. For simplicity’s sake, we use taxable bonds in this example.

^b Such as money market funds and Treasury bills.

Source: Compustat, DataStream.

As you can see from the table above, over the long term, stocks provided the greatest return, but also the greatest volatility. Cash was least volatile, of course, but also the least profitable. Bonds were in between. The risk/reward tradeoff seems obvious: the greater the risk, the higher the long-term reward. Of course, we are actually trading off one kind of risk for another. Stocks may be risky because in the short term you could suffer a big loss. But cash is risky, too, in that you may not get enough return from it over time to meet your long-term needs. Let’s take a closer look at some of these asset classes.

Money Markets’ Reputation is Deceiving

One of the “safest” investments—money-market instruments—may actually be quite risky. Treasury bills, money market funds, commercial paper and certificates of deposit maturing within a year are practically as liquid as cash, virtually guaranteeing repayment of their face value, and fluctuate negligibly if at all. But suppose you’re counting on Treasury bills for income to live on, and interest rates begin to decline. Each time you roll over an expiring bill, you have to reinvest at the new, lower prevailing rate. You won’t lose a penny of principal, but your income will fall, perhaps precipitously. In the five years between 1981 through 1985, you’d have seen it cut in half. And money-market returns are low to begin with, affording scant protection against inflation, especially after taxes.

Prize Bonds for Stability, Not Growth

Bonds fall farther out than bills on the risk/reward spectrum. You receive regular interest payments that are generally fixed until maturity—hence the term “fixed-income” securities. You get back your investment when the bond comes due, or matures. Default is unusual, but bonds can be risky even when the issuer is as gilt-edged as the U.S. government, because whenever interest rates rise, bond prices falls. Long-term bonds get hit hardest. After all, if you’ve tied up your money for 30 years at 5%, and market rates climb to 7%, you stand to earn less than the going rate for the next three decades. Still, swings in bond prices tend to balance out over time, so that most of what you earn winds up coming from interest. Indeed, rising interest rates can work to your eventual advantage.

Bonds with maturities of two to six years generally have provided the beet risk/reward tradeoffs—fatter returns than the money markets and about as much long-term return as far-riskier long-maturity bonds.

Stocks’ Bumpy Ride to Big Payoff

The case for stocks is long-term growth. What you buy in a stock is a stake in a company’s profits and growth potential: the payoff comes in the form of dividend payments and stock-price increases. No financial asset has come close to stocks for long-term return. But stocks are risky in the short term. The U.S. stock market lost money (often a lot) roughly one year out of five between 1965 and 1999, and its annual return during those years varied from a 38% gain in 1995 to a 25% loss in 1974.

The longer your investment time horizon, however, the more the risks tend to reverse. In the sense of losing ground to taxes and inflation, stocks become less risky over long periods, fixed-income securities more so. Over a 35-year period, stocks had a compound annual growth of 5.6% after taxes and inflation. Bonds about broke even, and Treasuries lost money.

Even from a straight return perspective, stocks are strongest over the long term. Over rolling five-year periods from 1964 through 1999 (1960-64, 1961-65, etc.), U.S. stocks lost money only twice, and they made money in every 10- and 15-year period. You can take nothing in investing for granted, of course: Stocks may not be the best returning asset class over the next 10 years. After all, they gave up their 10-year advantage in the turbulent 1930s and 1970s, and even Treasury bills outgained stocks over a number of 10-year spans

in the 1960s and 1970s. For these and other reasons, it is wise to diversify among stocks and bonds.

There's More to Life Than Top Return

Feelings matter, too. Stock investing can drain you emotionally, to the point where you can lose out on their long-term payoff. Since 1960, the Standard & Poor's 500 stock index dropped at least 10% nine times. These bear markets lasted just under a year on average, with stocks returning to their prior peaks nine months after they hit bottom. But only those who had kept their money in the market enjoyed the recoveries. A balanced stock/bond portfolio that mutes stock losses can help ease the anxieties. If you take on more risk than you can handle, you probably won't stay invested long enough to reap the ultimate payoff. As one Wall Street sage advised, "If you don't know who you are, the stock market is an expensive place to find out."