

Expert View

Four Myths about Investment Risk that Could Lose You Money

By Guest Writer Jarrett Solomon

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Occasionally something crosses my desk where I couldn't have said it better and today is one of those days. I got to know Jarrett Solomon, an investment advisor who works with high net worth clients to help maximize the effectiveness of their comprehensive wealth plan, after reading his work in Financial Advisor—I love to read insightful writers and he is one of them. So when he sent me this article on how he sees investors are missing the point about risk – that they are basing their decisions on myths rather than reality – I wanted to share it.

I spend a lot of my working hours with the concept of risk trying to identify it, manage it, explain it, plan for it, and ensure that clients are appropriately compensated for it. Given my close working relationship with risk, I decided to check out its official meaning in the Merriam-Webster online dictionary. The one definition that pertains to investing reads as follows: “the chance that an investment (as a stock or commodity) will lose value.”

I must say that I was taken aback by this definition. Not that I look to the dictionary as the paragon of forward investment thinking, but I find that this definition provides a disservice to investors and identifies a potentially hazardous way to manage a portfolio. If you have not studied investment portfolio methodology, you might read that definition and think, “as long as I keep my investments in vehicles that will not lose money (i.e. cash and cash equivalents), I am not taking any risk.” In fact, this notion could not be further from the truth. The possibility that an asset might depreciate certainly represents one form of risk. However, if you escape that risk by parking your assets exclusively in cash-like investments, you are likely exposing yourself to the possibility that inflation will silently erode the purchasing power of your portfolio, which can lead to the ultimate risk of not achieving your long-term goals.

Here are some other myths associated with investment risk that I commonly come across:

Myth: Volatility is a good way to determine if I should own an investment.

If you owned each of your investments in a vacuum, volatility would be the appropriate measure of risk. Because you do not, volatility is employed correctly when helping to decide on an overall portfolio that

is in sync with your risk/return profile and unique variables (risk tolerance, investment time horizon, and cash flow needs). When you are looking for asset classes and funds to add to an existing mix, volatility does you no good. Instead, think about correlation – how investments will work together in your portfolio. The manner in which the potential newcomer to the portfolio behaves relative to your existing investments is the most important factor.

An example of this distinction can be explained when looking at asset classes like commodities and real estate. Both of these asset classes have historically displayed significant levels of volatility. However, they have also historically shown low correlations with other more traditional asset classes like equities and fixed income, and even though as a stand-alone asset class they can be characterized as volatile, adding them to a portfolio of stocks and bonds may actually reduce the amount of volatility your portfolio experiences. Ultimately, a fully diversified and efficient portfolio will consist of various asset classes with low correlations with one another, each of which will behave differently in different investment environments and will protect you against different types of risk.

Myth: If I pick a few good stocks and hold them, I'll beat inflation risk.

Just because you own a few stocks in a few different sectors, it does NOT mean that you are appropriately diversified. In addition to having investments in different asset classes, it is imperative that you are not unnecessarily concentrated within a few stocks or sectors. We investment geeks refer to this concept as unsystematic risk. Just because you own stock in Microsoft, GE, and Home Depot, it does not mean that you are sufficiently allocated to large-cap companies. We just completed a year where most all equity indices appreciated in double digit amounts. Instead of a diversified mix of equities, if a large portion of your equity portfolio was invested in BP, your experience in 2010 would have been much different. In order to reduce the unsystematic risk in your portfolio, make sure you are choosing mutual funds or ETFs rather than single stocks to provide you with exposure to asset classes.

Myth: I own companies that do business globally, so international investing is not necessary.

It is true that we are living in an increasingly globalized world. It is also true that, more often than not, when you are investing in large companies domiciled either domestically or abroad, you are investing in companies whose footprint stretches across more than just one nation. However, that does not mean that you do not need to look at international companies for your portfolio. For one, investing internationally can bring necessary exposure to other currencies that will behave differently than the U.S. dollar. This notion is becoming increasingly important as the United States government has taken aggressive fiscal and monetary measures to stimulate domestic growth and may ultimately cause a weakening of the dollar relative to other currencies. Just like you would not want all of your assets denominated in Euros, the same can be said about investing exclusively in dollar-denominated assets.

In addition, if you compare the performance of the different markets, it is clear that domestic and international markets do not move in lock step with each other. In November 2010, the S&P 500 (the benchmark for U.S. equities) was essentially flat, while the MSCI EAFE (a widely-used benchmark for international equities) depreciated almost 5% over concerns of some of the European countries'

sovereign debt. While in this case U.S. stocks outperformed international equities, that is certainly not always the case and is an example of why a diversified portfolio should contain both asset classes.

Myth: I can reduce risk by investing in stocks in good periods and sitting in cash during bad periods.

Wouldn't it be nice to know when the market was going to appreciate and when it would go through periods of downward pressure? I certainly would have retired a long time ago if I could accurately predict the direction of the market, and the same goes for the "experts" on TV who say they can predict market movements. In fact, most studies prove that trying to time the market can be detrimental to the success of a portfolio. The long-term trend of the market is up, and as long as you hold true to your strategy and are appropriately diversified across and within asset classes, your portfolio will experience long-term growth.

Children often hide under their beds when they are scared of something. As we emerge from a period marked by extreme volatility and uncertainty, I can sympathize with those that want to do that same thing with their hard-earned savings. However, it is imperative to remember that keeping all of your assets in protected but low-yielding accounts may expose you to other risks you hadn't considered, such as the ultimate risk of outliving your money. If you can identify an appropriate breakdown between risky and non-risky assets, sufficiently diversify your portfolio across a variety of asset classes that perform differently in different market environments, and focus on limiting your exposure to other unnecessary types of risk, you are putting yourself and your family in the driver's seat to lead comfortable, financially-secure lives.

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