INTEGRIS
WEALTH MANAGEMENT

<u>THE LONG TERM RELATIONSHIP BETWEEN RISK & REWARD</u>

Personal Investing Series

Article 5

There is a fundamental concept that both amateur and professional investors need to remember. That concept is that the marketplace demands a higher expected return from investments that have higher expected risk. This is not such a surprising concept really. For instance, cash (e.g., savings account, CD, or money market mutual fund) will generate only a modest annual return and it is almost impossible to lose your original investment. You also probably know that stocks can generate 30% or more a year, but they can also lose money. On October 19, 1987, for instance, stocks lost 23% in a single day! **It is important not only to understand this concept, but to ensure that our investing behavior conforms to it.**

How many times have you been tempted to invest in a sure thing - something that was promising outsized returns for no risk? If someone were to approach you with an investment idea that had an expected return of, say, 20% over one year with no risk, then you should think twice before you reach for your wallet. The risk-free rate, that is the rate you can earn without taking investment risk, in today's market is about 3%. So a 20% risk-free investment opportunity is either based upon an optimistic return forecast, or more probably, is based upon a risk assessment that is wrong.

Risk is very easy to underestimate. You may remember reading in 1998 about a hedge fund called Long Term Capital Management. Investors in Long Term Capital lost 90% of their money. Some of the guys running Long Term Capital were Nobel Laureates in finance! After the fact it is always crystal clear what risk you did not account for, but of course by then, it is too late. If an investment has a high return, assume that it has a high risk. **Don't assume that if you can't figure out what the risk is, that it doesn't exist.**

So why is it that this is such an immutable rule? An example might help illustrate. Let's say there is an investment that costs $100 and that will be worth $120 at the end of one year. Let's also say that the investment cannot go bankrupt and the $120 ending value is somehow absolutely guaranteed. Finally let's assume that the risk free rate is 3%. There is no question this is a fabulous investment - getting 20% risk-free while the rest of the world is getting 3%! So let's buy as much as we can. Oh-oh, problem. The guy who already owns this investment won't sell. He knows he already has a great deal. Why would he sell it off to either you or me? What is he going to do with $100 that we would pay him? Invest in a normal risk-free investment and get 3%? Invest in stocks where he has a chance of earning 20%, but also a chance of losing money? A 20% sure thing is a lot better than a 20% maybe.

But wait, let's say this guy is really in a bind and needs the $100. So just as you are about to hand over $100, some greedy spoilsport who also wants into this deal says, "Hey, I'll pay $101". Well, not to be outdone, you counter with $102. After all it is still almost 18% risk-free. Your greedy nemesis bids $103 and so on up to about $116.50. Why $116.50? Well, if you grow $116.50 to $120 over one year, it is just about 3%. Anything below $116.50 is still an attractive risk-free investment, anything over is not.

In either case, you will not get 20% risk-free. You may get the 20%, or even more, but you will most likely have taken on some risk that you did not understand or appreciate when the investment was first entered into.

Gifford Lehman
updated 3-2006