INTEGRIS
WEALTH MANAGEMENT

MORE ON RISK

Sickness vs. Death

Personal Investing Series
Article 7

Investment professionals think of risk in terms of volatility. Volatility is simply the ups and downs of prices. The trick in dealing with this kind of risk is to diversify, which smoothes out the highs and lows over the short term. The other trick is matching your investment horizon to the type of investment. If you are invested in something which has volatile prices, you need a longer investment horizon so that you can ride out the down periods. Highly volatile assets are for the long term only (10 years or more). If you should need to cash out of the investment sooner than that, then find an investment that is less volatile.

There is another kind of risk I want you to consider. It is sort of the difference between being sick and being dead. For the most part when we don't feel good, we get better with the passage of time. But if you are dead, well, there is no recovery from that. When we talk about volatility, it is analogous to being sick and being healthy, just the normal ups and downs. For the average investor, it is good to utilize investments that may go up and down, but can't die on you.

A well diversified stock mutual fund will go up and down, but unless the entire economy goes belly up, (in which case we would all have much bigger things to worry about), the portfolio will continue to be worth something. As long as it is alive, there is the chance it will recover given enough time. That is not true if you buy an individual stock. Individual companies go bankrupt, when that happens, that portion of your portfolio is not sick, it is dead.

I try to have my clients make investments where it is hard to imagine a situation where the investment would cease to exist. Examples would be well diversified mutual funds that invest in large US stocks, small US stocks, European stocks, Asian stocks, emerging market stocks, investment grade US bonds, high yield bonds, international bonds, and real estate stocks. Each of these asset classes are susceptible to substantial declines in value, and could take years to recover, but none of them should just disappear forever.

There are some investments that are more susceptible to "death" than others. Stock of individual companies is one example. These can become worthless if that company goes bankrupt. The same is true for individual corporate bonds. If you have a well diversified portfolio of stocks or bonds, then this is not a problem. But the average investor usually does not have the funds to put together a portfolio that is as well diversified as what a mutual fund company can do. For instance, an individual investor might own 1 or 2 or maybe even 10 corporate bonds, where a fund manager would probably own 100 or more. If a credit problem develops, you could lose your entire investment. A fund manager would lose only a portion of his well diversified investment, and maybe not even that as the fund manager is better equipped to identify developing credit problems and sell the bond before it actually dies on him.

Limited partnerships also represent an investment that can die on you. Limited partnerships have been known to have poor internal controls, which can allow a "rogue" trader to make imprudent investments or can lead to fraud. I have seen both happen with limited partnerships that otherwise were very attractive investments. Another problem with some limited partnerships is something called "leverage". Leverage is when a manager takes not only your money to invest, but goes out and borrows even more money to invest. If the cost of borrowing is less than the return made on the investment, this is great and you can profit handsomely. However, if the partnership loses money, your entire investment can be lost very quickly.

That is not to say that any of these are bad investments, as they can be outstanding ones. But the average investor is often unable to build in the same level of diversification owning individual securities as a mutual fund can. Nor is the average investor able to assess the risks of leverage or other obscure risks associated with limited partnerships.

So when considering an investment, ask yourself if there is something about the investment or the vehicle in which the investment is delivered that could make it susceptible to being dead.

Gifford Lehman
updated 3-2006