

RISK OR RETURN?

Over the years I have had interesting conversations with investors and there are always questions asked that stand out to me like, “How am I financially compared to other people my age?”, or “How much money do I need to retire?” But the one I would like to explore today is “*Do you think we should take more risk?*” The short answer in most situations is no. After all, it isn’t **risk** that we want, it’s **return!** But *how* investors accept risk to get a return is the purpose and scope of this article.

Most investors equate “taking more risk” with investing more of their money in stocks. This seems appropriate as stocks are the main investment used by most investors and happen to be the primary investment available in company-sponsored retirement plans. So when investors consider taking more risk, whether the result of need or greed, they typically increase their exposure to stocks. But what if there was another way? After all, just because they increase their exposure to stocks does not mean they will necessarily get a higher return. Consider Cisco Systems as an example. For investors who initially purchased this stock in the early 1990’s they were handsomely rewarded for taking that risk. But for those who bought in the late 1990’s at \$60, \$70, or \$80 per share they were penalized for taking that risk. So this tells us first and foremost that **value** (reflected by price) is a very important consideration for taking risk.

Now when value is uncertain, as is the case today, my preferred method of “taking more risk” is comprised in the *strategies* used to take that risk. The strategy quoted above is called “being long” a stock. It means an investor buys today with the expectation of prices being higher in the future. But let’s consider others. A few examples include asset allocation, distressed debt, convertible arbitrage, long/short, concentrated equity, and global macro. Investors who are not comfortable

deploying these strategies on their own may hire a manager to diversify their risk through these strategies. A good way of thinking about these types of strategies would be the “*opportunity cost*” of risk.

For instance, what if an investor utilized an asset allocation strategy through the use of a mutual fund? One strategy we employ allows the manager to invest in different combinations of assets at any point in time and includes buying stocks, bonds, commodities, cash, and even shorting the stock market (i.e. profiting from a decline in prices). How do I perceive “risk” through this strategy? Well, what if the manager is mostly in bonds when the stock market is rising? The investor would likely forego *some* return. Or what if the manager is shorting the stock market when it is rising? The investor would likely experience a loss. You see, just because an investor exposes their money to this “risky” strategy does not mean they will be exposed to the same “risk” as the stock market. So the “risk” in this case is the opportunity cost of the manager employing the strategy *effectively over time and being right more times than they are wrong.*

These diverse strategies offer the potential for risk-adjusted returns to an investor, over time, without complete exposure to the stock market – whether good or bad. And they can be used by investors to diversify their portfolio to provide for more restful nights without total sacrifice of return. So the next time you are considering taking more risk I suggest you change your mental construct and consider “*how* might I go about increasing my potential return?”



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