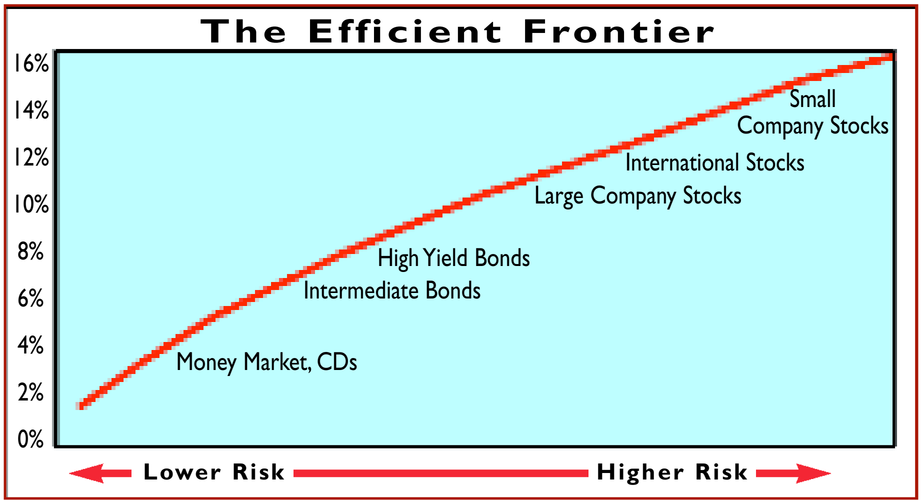

Is the Stock Market Too Risky?

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Investors, meaning anybody holding stocks or mutual funds, have had a crude awakening to the reality of stock-market risk as the major stock-market indexes started going into a tailspin since December of 2007. Sometimes, novice investors get the notion that they can always expect double digit returns from the stock market without any negative periods. This would be nice, but obviously, not a reality.

A constant theme I tell my clients is that investment performance is linked to how much risk they want to take. If you want a portfolio that returns 10% a year, you are going to have to take some risks. This means investing in stocks or, what I recommend, stock index funds. Historically, the stock market has performed better than all other types of investments because stock market returns have seen more highs than lows over the last 80 years.

Above is a chart that shows the average returns for different types of investments. If you have any aversion to charts, numbers, or percentages please bear with me, because a basic understanding of this chart will give you a solid foundation on how to make investment choices. The vertical column shows return percentages and is called the Y-axis, and the horizontal line on the bottom, measuring risk, is called the X-axis.

Economist Harry Markowitz started developing the concepts of this chart in 1952. His discovery of the relationship between investment risk and return opened up a new realm of investment theory. He coined this relationship the "Efficient Frontier." It is depicted as the red graph line in the chart. Mr. Markowitz went on to win a Nobel prize in economics in 1990 for his efforts and is now considered the father of the Modern Portfolio Theory.

This chart is meant for illustration purposes only. Do not rely upon this chart to predict future investment returns.

Risk (on the X-axis) is defined as how much an investment can go up and down from its average. The technical term for this is "standard deviation." The higher the up and lower the downs means the investment would have a lot of variation and therefore would be more risky. The question is, what would be a good investment when the risk and expected return are both taken into consideration?

For example, suppose someone wanted to buy a high-yield bond, commonly known as a junk bond. Historically, this type of bond has averaged around 6.4% a year. However, the risk on this bond, measured by its standard deviation, was similar to a small-company stock, which is the riskiest investment on the chart. Markowitz would have determined that this would not be a good investment based on the level of risk and the rate of expected return. Seems simple, but at that time, no one had related risk and return and applied it in a common-sense way to investing.

Unfortunately, most individual investors, financial advisors, and the media today have still not applied Markowitz's sound concepts. They continuously focus on past performance rather than linking the investment with the corresponding risk. It's like being in the middle of summer and thinking that winter will never come. Anyone living in Montana knows that winter is always just around the corner!

Investment performance and investment volatility are two sides of the same coin. Neglect one, and you are more than likely going to have an unbalanced portfolio, which could have devastating results if not corrected. Finding the right balance between investment performance and investment risk should be the focus of every long-term investor.

In a recent study, researchers came to the conclusion that while **6% of the returns in a portfolio were due to security selection and 2% to market timing, 92% of the returns were due to proper asset allocation**. This means that if you are a long-term investor, it is a much better use of your time and resources to find the right mix of stocks, bonds, and other investments, rather than trying to pick the hottest stock or listening to some proclaimed market guru telling you when to buy or sell.

If you want to know more about asset allocation, I recommend *The Intelligent Asset Allocator* by William Bernstein. It's definitely not a novel, but if you can get through the technical jargon, the book will give you a good, basic understanding of how to allocate your portfolio. If you would rather not study a whole new field of learning then get professional help. I recommend a fee-only advisor, who is not only conscious about proper asset allocation techniques but about the costs of investments. The series of *Natural Life* articles I wrote entitled, "Fleecing of the American Investor," will give you a good idea of what type of investments to avoid.

In closing, market volatility is the price we pay for being long-term investors. Just make sure you do not have too much risk or too little. Keep it balanced. A balanced portfolio is like the foundation of a house. Keep it strong and it will serve you for many, many years into the future. ■

Alan D. Hearn, CFP® is a fee-only advisor and tax professional who has helped many people restructure their portfolio based on the Modern Portfolio Theory. He can be reached at 406-222-5417.