Risk Assessment vs. Absolute Return

Does greater risk equal greater return? After many years in the market, ongoing research and comparative study, Lynch Financial Advisors concludes that taking risks with your investment dollars doesn't always add up.

Abstract

Risk Assessment tools – originally designed for wealthy investors in the bygone era that introduced mutual funds – are now outdated. Unfortunately, Risk Assessment tools are dangerously misused in today's market. You might be surprised to learn that even today's typical Diversified Portfolios – commonly regarded as stable and conservative investment strategies – carry unnecessary risk. Though investors often position themselves as prognosticators, the ups and downs of the market are simply impossible to predict. Rather than playing the Risk Assessment game, today's investors should carefully consider their personal financial goals and focus on the long-term gains fostered by a portfolio based not only on diversification, but also on a financial principle known as Absolute Return.

Glossary

Absolute Return is the actual financial return of an entire portfolio. In the world of asset management, an advisor that focuses on Absolute Return is continually evaluating Downside Risk and working to have positive returns, regardless of the state of the market.

Downside Risk is a measure of how much negative return an asset or portfolio has. Usually it implies that the portfolio involves higher-risk investments, because it has a higher probability of going backward.

Risk Assessment is a popular investment tool, usually based on a series of evaluation questions, which helps determine your ability to weather the Downside Risk of a portfolio.

Index Investing is a type of portfolio that concentrates on a set of indexes. Indexes, which are groupings of assets (large caps, mid caps, etc.), often provide the core for Diversified Portfolios.

Non-Correlated Assets are assets that are not tied to one another and don't necessarily move in sync with one another.

While managing today's financial portfolios, middle-income investors typically go through some type of risk-tolerance assessment. Risk Assessment tools are commonly used by financial advisors, investment counselors or brokers, and insurance agents. They are also a staple of retirement plans, such as 401(k)'s and 403b's. Similar tools can be found online that help you assess your ability to manage risk. Each tool offers a different perspective as to what your risk tolerance is, and they are built to help you allocate

funds relative to the risk you are willing to take.

However, Risk Assessment tools are failing as a core investment strategy. Paladin, a reputable think tank, recently conducted a survey that revealed "Millions of investors fire financial planners and advisors every year because they did not receive the results and services they expected. Then more than 91% of the investors hired replacements, hoping the new advisors would be better than the ones they fired."[1]

Since Risk Assessment is such a prevalent strategy, the study suggests a relationship between how much risk investors are taking on and their actual returns. It appears that in most cases, expectation exceeds the actual returns – or that returns were simply disappointing. After a while however, the cycle of taking risks associated with risk assessment tools, receiving low returns, and changing advisors brings to mind a dog chasing his tail.

Risk Tools Are Upside Down

The Paladin study makes it apparent that financial advisors managing middle-income portfolios must create financial solutions that can weather the ups and downs of the market. Bert Whitehead, ranked by *Worth* magazine as one of the top 100 financial advisors in the country, has maintained for years that traditional Risk Assessment tools are upside down.

Whitehead's philosophy is simple and straightforward. Investors with a high tolerance for risk are typically entrepreneurs. Entrepreneurs typically own businesses. Business owners typically have a large amount of their net worth tied up in their business. For example, their retirement is often based largely on how well their business does. Tying up a large percentage of assets in one investment is by definition very risky. However, Risk Assessment tools will place this investor in an aggressive portfolio, when they should in fact maintain a very conservative port.

On the other hand, investors with moderate-income jobs, such as teachers, social workers and other government employees, typically test as conservative and are less willing to take risks, according to Whitehead. Although they crave stability, these investors can handle more volatility in their portfolios, because they often have the safety net of a pension plan. Even if their portfolio doesn't do well, the impact on their retirement is limited. Unfortunately, because of Risk Assessment, a large population of investors will be placed in the wrong risk category.

Why is this happening? According to Whitehead, Risk Assessment tools started with the advent of mutual funds. Historically, a broker would be able to garner new commissions by selling stocks and buying new stocks. But when mutual funds came along, the large basket of stocks in the client's portfolio was replaced by mutual funds. The idea of risk tolerance was linked to the idea that as clients progressed through different stages of life they needed to reallocate their portfolio. Reallocating meant selling current mutual funds and buying new mutual funds – a new way for the broker to make commissions.

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[1] Why do Millions of Investors Fire Their Financial Advisors Every Year? June 27, 2006, Palidin Registry, LLC

This was the case until experts, including Whitehead, began to question how Risk Assessment tools worked. Whitehead concluded that they are upside-down – that there is actually a dangerous *inverse* relationship between these tools and how portfolios should be allocated. With Risk Assessment tools, investors that shouldn't take risks were; and those that could take risks were not.

Doing the Math

Before you start investing, is important to understand the common ideology of traditional Risk Assessment tools:

- You *can* get a higher rate of return by taking on more risk. Financial advisors will often tell you that they can give you a greater return albeit with increased exposure to downside risk. To express this as a mathematical equation: To get a 6% return, you may have a downside of negative 2% to your overall portfolio. However, to get to 8%, it's common to have a downside risk of minus 10-20% – which means that your portfolio could go down that much in any given year. The problem with the down years is that you have to get close to a 12-30% return to offset the larger downside. As you can imagine, these numbers will strain the relationship between advisor and investor. Remember, 91% of financial advisors are replaced. The dog is not merely chasing his tail. To get an idea of the day-to-day and year-to-year fluctuations of the market, imagine the dog watching a yo-yo go up and down.

- With Risk Assessment tools, your advisor is analyzing historical returns – and betting that history will continue to repeat itself the exact same way. The risk management analysis for which you are paying your advisor is completely based on historical trends. So your outcome is only as good as the future relates to the past.

Based on this, it is fairly apparent that, as Whitehead surmises, the commonly used risk tolerances used are inadequate. To take it a step further, Risk Assessment tools are simply not useful. It's easy to make the argument that it really doesn't matter whether you conduct a Risk Assessment at all.

We have already concluded that entrepreneurs need to have a stable portfolio, because of all of their risk involved in their business. And although teachers and government employees might be able to take more volatility, it's safe to say they need overall stability in their portfolio. But there is another reason that stable portfolios are important: Because with jobs, relationships, children and travel, there is so much instability in the *rest* of our lives. Your portfolio shouldn't be adding to your stress; it should be part of your stability. We've seen that in bear markets, it can even be scary to hold bonds. But there is a big mental difference between a portfolio that drops 10% during a downturn and one that goes down 20%.

So perhaps the whole idea of risk tolerance doesn't make any sense. Is there any evidence to support this? In a landmark 20-year study, the Dalbar Company, an independent financial research firm, came to this conclusion: "Examining the flows into and out of mutual funds for the last 20 years, the Dalbar

study of investor behavior found that market timers in stock mutual funds lost 3.29% per year on average. Over a period when the S&P grew by 12.98%, the average investor earned only 3.51%."[2]

To fully comprehend these numbers, let's compare the three groups that Dalbar is talking about here:

1. Market timers – a group that focuses on buying and selling mutual funds based on market conditions –lost 3.29%).

2. The average investor – assumed to be the sum-total of all mutual fund investors – gained 3.51%.

3. Standard & Poor's 500 index – a basket of 500 large cap stocks – gained 12.98%.

In short, whether you were a market timer or an average investor, you lost significantly compared to the S&P 500. Ironically, the S&P is a basket of U.S. brand-name stocks – with little diversification and a lot of volatility.

Aiming Toward 6%

The S&P is volatile and it had great returns, which is why it is considered more risky. Indeed, most analysts would agree that the non-diversified nature of just using a basket of U.S. stocks is risky. So doesn't that mean that higher returns were generated by taking more risk? Absolutely – but that's only half of the picture.

While the S&P (and probably the overall market itself) produced good returns, neither the market timer nor the average investor did well. And more than likely, all of those investors that fired their advisor didn't do well either. Why is this?

There are a number of possible reasons, but one likely theory is that because of diversification, their returns were lower. This would make sense, because just investing in equities alone would likely yield a higher rate of return. When investors put bonds and other assets into their portfolio, the overall return typically goes down.

Significantly, there are numerous studies that suggest that the majority (approximately 80%) of fund managers don't beat the market over a 5 to 10-year window. Over a 20-year timeframe, the number drops even more. So if we look at the average equity fund, for example, we may see only an 8% rate of return, compared to the market's 12.98% return over the same time period. And, averaging in bond funds and other types of mutual funds, the average portfolio likely would creep down to around 6%.

Of course 6% is a much better number than the average investor's return (3.51%) and the market timer's loss (minus 3.29%) per year. With hundreds of thousands of financial advisors in the United States, you would think that the average investor would do much better. Even worse is that a huge percentage of advisors for those average investors work for large institutional firms, such as Merrill Lynch, AG Edwards, Northwestern Mutual, etc. We aren't suggesting that these firms are responsible

[2] Dalbarinc.com

for the underperformance of the average investor. However this data clearly suggests that the large brain trust of these firms appears to be not nearly as smart as the market.

Despite all of the tools to help investors determine their risk tolerance – and all of the financial advisors out there – the average investor continues to make big mistakes in terms of market timing and overall investing.

Your Definition of Risk

So if Risk Assessment tools aren't working, how should you invest? Despite all of our above reasoning, intuitively it still seems logical that greater risk would equal greater return. But risk depends on your perspective.

Think about your definition of risk. Most people think that they are doing a good job by not touching their volatile portfolio when it goes up and down. After all, those that are taking more risk will invariably have portfolios with larger swings in returns. They do understand that they have a higher risk of downside in any given year – but they are willing to take that risk because they have a long time horizon. And when discussing risk, time may be the most important variable.

Best-selling author Suzy Orman says an investor needs a minimum of 10 years in the market. But to wait out market volatility, you often need to have a 30-year horizon. And even after 30 years, you have to time your exit to make sure you get out at the right point. There are many studies that suggest that most investors – let alone financial advisors – frequently fail to coordinate this timing.

Let's take the example of a 20-year-old investor. He is not planning to retire for 45 years. He goes into the market for 15 years, but then decides he has to lower his risk – so he gets prepared to move out of the market. This is basically what we all have been advised to do -- adjust our portfolios as we get older.

But what happens if he is in a down year when he tries to get out? It's not unlikely – since 1926 we have had 23 years in which large caps retracted and 25 years in which small caps retracted. Further, we had 13 years in which the large caps retracted more than 10%, and five times that the market retracted more than 20%. That's a retraction of 20% every 16 years on average.

Again, the unfortunate conclusion is that the market fares better than the majority of the investors. Most investors tend to move depending upon the market news. To determine why risk does not always equal return, let's look a little deeper. Assume two options for your portfolio:

<u>Option A</u>

Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10

36%	-25%	-17%	17%	4%	-31%	-20%	53%	57%	25%

Option B

6% return every year.

Which one do you take?

Option A shows small cap market returns over a 10-year period. At which point would you have changed your advisor? What type of return would you have had if you didn't put in any additional money? 10%? 8%? How about 5.5%? (This example represents returns from 1968-1977)

Meanwhile, Option B would have given you an 8% better return.

Now the above scenario does have more down years than the average 10-year span. The point is, you don't know which 10-year period you will be working in when you are moving from one risk tolerance to the next. The standard investment model is to graduate from aggressive investments to moderate investments to conservative investments. But what if Year 2 was the year that you were supposed to move from aggressive to moderate? You would have lost 25% of your portfolio. If it had been Year 6 or 7, you would have cut your portfolio in half. Perhaps even worse, you would have missed the huge upswings in Years 8 and 9.

Next, what type of return would you have with Option C?

Option C

Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
29%	21%	-9%	-12%	-22%	29%	11%	5%	16%	5%

10%? 8%? 6%? Yes, 6%.

Option C shows the returns of large cap stocks in the U.S. from 1998-2007. The problem with this scenario is that the big down years deplete the capital to invest the following year. In fact, by the end of Year 5, all of the gains are depleted.

This highlights the fundamental problem with the standard 10-year time horizon: Most people don't have the patience to stand pat through the down years. And maybe they shouldn't. After all, why would you go through the drama of watching your portfolio drop by 22% – only to end up with a 6% return after 10 years? Compare that risk to the investors who returned 12.98% by investing in the S&P 500 for 20 years.

Minimize the Down Years

Most advisors believe they solve the problem by diversifying their clients' portfolios – spreading the risk across a number of different funds. But as the Dalbar study proves, diversity apparently doesn't reduce risk because the average investor is getting a worse return than the market.

So what is the answer? Minimize the down years.

This sounds simple, but it is often missed as a key to helping investors get to their objective of long-term gain and financial independence. The best way to minimize the down years is to construct a portfolio of investments that minimize the draw down in a given period. And here's another thought – hire a financial advisor that thinks differently.

Here are some suggestions:

1. Use multiple money managers to distribute your investments.
2. Make sure that none of them approach the market the same way.
3. Make sure that they each are managing different types of investments.

There is more and more data that suggests that the chance of more stable returns is increased by the ability of the financial advisor or money manager to freely move where they see value. This is called Style Drift. Whether you believe those studies or not, there is also compelling evidence that suggests a broad base of non-correlated assets can actually give an investor a higher rate of return than the market – while taking on less risk.[3] [4]

The Behavioral Side of Investing

There is more to minimizing the down years than just the math. Think about the behavioral side of investing. If you looked at your portfolio and saw that in years when the market was going down your portfolio went down only half as much as the market, you would be more likely to stay invested.

This is the benefit to using a portfolio that has less Downside Risk. It leaves the investor calmer than the other investors going through the same rough sea. And these benefits snowball – investors are willing to invest even more money when they see their investments are stable. People are more apt to save if they feel that their hard-earned money isn't going to be lost.

Astonishingly, minimizing the down years is not a new theory. Back in 1979, a Princeton University professor named Daniel Kahneman studied how people behave in regards to their money. What he found was that the fundamental notions that markets are efficient and people act rationally were not true. Today, Kahneman's Prospect Theory is one of the most widely cited in economics:

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[3] Style Boxes: Outside the Box By Craig T. Callahan, DBA and C. Thomas Howard, Ph.D.,May 2006 Issue of *Investment Advisor* Magazine

[4] Don't Panic If Your Mutual Fund Is Drifting by Michael Weiss, CFA, http://www.investopedia.com

> "Prospect theory argued that people's degree of pleasure depends more on their subjective experience than objective reality, as the rational model of economics held. A shopper, for example, might drive across town to buy a $10 calculator instead of a $15 one, but forgo the same trip to purchase a $125 jacket for $5 less, illogically believing the greater percentage saved on the calculator makes the trip more worthwhile. Prospect theory led to "loss aversion," which explained why investors clung to losing stocks rather than selling. Investors were more likely to sell stock they purchased at $50 a share if it rose to $70 and seemed overvalued; but if they bought the same stock at $90 and it fell to $70, they were disinclined to sell, even if shares still seemed overvalued."[5]

Kahneman's research led to his winning the Nobel Prize in Economics, an award he shared with Vernon Smith of George Mason University.

The Advent of Absolute Return

The concept of Absolute Return is one of today's leading financial principles to emerge in the wake of Kahneman's research. Absolute Return is the actual financial return of a given asset , or of an entire portfolio – as opposed to the average or "arrhythmic return" of an asset or portfolio. In the world of asset management, a manager that focuses on Absolute Return is continually evaluating Downside Risk and working to have positive returns, regardless of the state of the market. The Absolute Return portfolio is clearly distinguished from Risk Assessment portfolios and typical Diversified Portfolios. Lynch Financial Advisors is a strong proponent of the Absolute Return method.

An Absolute Return portfolio is designed to minimize your Downside Risk. By contrast, a Diversified Portfolio strives to have different assets, but its main intention is simply diversification, not Downside Risk. That's because the concern of the typical Diversified Portfolio is performance on an average return over time – note that this is *not* equal to how your money grows inside of your portfolio. An Absolute Return portfolio reassesses how the portfolio is performing every quarter to ensure a low draw-down in any given quarter.

Absolute Return minimizes Downside Risk by implementing non-correlated assets. Non-correlated assets go well beyond diversifying away from typical large cap and international investments. An Absolute Return manager will often hedge the market and use alternative assets and commodities.

Diversification doesn't necessarily mean that a portfolio will work in any economic environment. In fact, most diversified portfolios work well only in strong markets. The typical diversification model includes large caps, international, small and mid caps. Non-correlated portfolios should have assets that work well in a down market. And all assets in the portfolio should have a different downside than the leading market indexes (i.e., Dow Jones or Standard & Poor's). In addition, all Absolute Return portfolios have a strict method for minimizing risk.

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[5] Hopeyen of the Associated Press on Jan. 2, 2002.

Tellingly, Absolute Return portfolios have more characteristics of the Yale Endowment than to a traditional financial advisor's portfolio. The Yale Endowment is one of the most successful endowments in the world. The managers of the Yale Endowment have long-term vision but they also must plan every year for money to come out of the endowment. As a result, this portfolio has a number of assets that most managers would never put in their portfolio, such as tree farms, oil and gas, international bonds, etc.

Absolute Return managers can employ a number of different strategies. They can hedge exposure in either direction of the market, to insure against frequent undervaluations and overvaluations of the market. They can use commodities and can either passively or actively invest in assets. Some Absolute Return managers will manage assets to look like bond returns. That may seem odd, but it makes sense: Bonds don't always produce steady returns. So if you can use equities and get a bond-type return, you would likely beat a bond fund. Since the bond fund will still go up and down, based on its net asset value.

Often people think of Absolute Return in the negative light of hedge funds, but this is not always the case. For example, a mutual fund can be managed with an Absolute Return ideology. And your financial advisor can manage with an Absolute Return ideology as well.

Your Biggest Risks

We need to think differently and move ourselves into a new world where homework and research and a strong understanding of the cyclical nature of markets help us minimize downside. There is obviously little correlation in the real world to the Risk Assessment that people implement and the returns they receive. In fact, in today's world the biggest risks for the investor are:

1. Not saving enough.
2. Not minimizing a portfolio's down years.
3. Bailing out of the market too early.

Other than a government secured bond, there is nothing that is 100% guaranteed. Taking more risk for five, ten or even 15 years or more, doesn't guarantee higher returns. As we have seen, most people actually get less return than the market. As an investor, you can't stick your head in the sand. As advisors, we can't be in the business of prognosticating or guaranteeing that history will repeat itself. But statistics show that this is happening every day, over and over again.

Conclusion

It is evident that by removing Risk Assessment tools from the equation, we can at least eliminate the notion that the advisor has any control over the market. Investors need to understand what they can and can't control. They can't control the market, but they can attempt to control their downside risk. Other than buying U.S. treasuries, investors can't control market volatility, But they can minimize the

risk of volatility by utilizing non-correlated assets and investment styles.

Finally – and most importantly, for the average investor – if they are using their portfolio as a means to retire, they need to make sure that their portfolio is not being managed to compensate for their overspending, or for their inability to save. The portfolio should be the bedrock of their future; a source of security and safety. If their portfolio is designed with this ideology, they will be able to enjoy the more important areas of their life: their family, their friends and their career. And they will be more relaxed and more successful in the financial endeavors that are within their control.

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