The biggest threat to your portfolio

Morgan Housel

Published in Sydney Morning Herald online on January 29th, 2013

BlackRock CEO Larry Fink once told a story about having dinner with the manager of one of the world's largest sovereign wealth funds. The fund's objectives, the manager said, were generational. "So how do you measure performance?" Fink asked.

"Quarterly," said the manager.

Why a fund with a time horizon measured in decades, if not centuries, would care about month-to-month performance is an example of what Fink called "a dangerous preoccupation with the short term". Individual investors fall for the same trap, and it skews their perception of risk.

What is risk?

Nearly every textbook and investment theory equates risk with market volatility. If a stock goes up or down more than the rest of the market, it's said to be riskier. If the stock market has a down year, people start talking about the risks of owning stocks.

But this is a weird way to think about risk, especially if you're a long-term investor.

Charlie Munger, Berkshire Hathaway's vice-chairman, describes risk like this: "Using volatility as a measure of risk is nuts. Risk to us is (1) the risk of permanent loss of capital, or (2) the risk of inadequate return."

Risk, in other words, isn't when stocks go up and down. That's just something stocks do. Risk is when an investment goes down and can reasonably be expected to stay down forever, or when an investor fails to earn high enough returns to fund a goal like retirement.

It's not what you think

If you're more than a decade from retirement, the biggest risk you face isn't that stocks will wobble around from time to time. It's that your long-term investment returns will be so low you won't be able to retire.

Think back to 1998. The Dow Jones plunged 20 per cent in the middle of the year, after Russia defaulted on its debt and Asia spiralled into a financial crisis. The All Ordinaries fell 13 per cent in a matter of six weeks.

At the time, the plunge was touted as an example of how risky stocks can be. "Investors are buying bonds because there is more perceived risk in the stock market," the *Kansas City Star* wrote during the fall.

Hindsight uncovers the folly

But 15 years later, how many individual investors still care about the ASX's 13 per cent plunge or the Dow's 20 per cent fall of 1998? None. No one. Few even remember it. The Dow recovered all of its losses within four months, the All Ordinaries within six months, and the world went on.

What was proclaimed to be a clear example of risk was irrelevant and gone in less than half a year – a strange definition for those investing with decade-long time horizons.

This is an important topic today because the sharemarket's recent volatility has caused investors to re-evaluate how risky it is. Millions of investors have decided shares are too risky and since 2008 have ploughed more than $US1 trillion into bonds, which are typically less volatile.

The price of 'safety'

Time will tell how this story plays out, but odds are it will end disastrously. In an attempt to "lower risk", investors are buying bonds at record-high prices, in many cases with yields so low they are begging for negative future returns after inflation. Bonds may be one of the riskiest bets you can make today, and I don't think most investors even realise it because they're so caught up with avoiding short-term volatility.

As the chief investment officer of a major bank recently pointed out: "Many investors do not understand what happens to a bond fund when rates rise." Here's the answer: You'll probably lose money. The last time interest rates were near current levels, in the 1950s, Treasury bonds lost 40 per cent of their inflation-adjusted value over the following three decades. For retirement plans that are already woefully underfunded, a repeat would be devastating.

Foolish takeaway

As you work out the choice between stocks and bonds, ask yourself more than: "How much risk can I take?" Ask: "What is risk?" If you have more than a decade to invest, the extra volatility of stocks probably shouldn't scare you. Losing a permanent fortune on bonds, on the other hand – now that is risk. The same thinking can also be applied to so-called "safe" and "blue-chip" shares.