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Anthony Christensen

ACCESS Wealth Management

Intelligent Investing

Investment Risk: Understand And Minimize It

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Most investors don't know how much risk is in their portfolio. Look into your time horizon and alpha before determining your risk tolerance.


Tony Christensen

It's amazing how many new clients walk through my door with no idea how much risk is built into their portfolios. We're talking wealthy, experienced, well-educated investors, sometimes even celebrities and pro athletes whose portfolios were developed by reputable professionals. But the truth is, too many investors don't understand risk or how to manage it. It's not a popular subject. What financial adviser wants to focus on how much you might lose when they're trying to sell you on an investment? But the smart ones do.

While it might be more enticing to talk big returns, steep gains and best-case scenarios, I've always thought it's the worst-case scenarios that are the most telling. You wouldn't take a new medication without considering the potential risk, would you? Sure, you might lose 25 pounds, but if there's a strong chance you'll have a heart attack, would you accept that kind of risk? Your money shouldn't be any different.

Deviant Behavior: Standard deviation is a statistical measure of volatility, or how much a return may vary from the return you expect. But while some think studying the deviation is enough, I take it one step further. I have a rule of thumb that I use to determine how much risk is involved: Take the standard deviation and multiply it by 2.5, which is how much you should be prepared to lose. If that's not something you are willing to risk, the investment may be too risky for you.

Alpha Comes First: Alpha helps determine how much you are being rewarded for the risk you take and is absolutely vital to consider. Positive alpha means the investment performed better than would be expected given its risk, while negative alpha means the investment produced lower returns than expected when compared with the risk. I believe it helps you gauge if a risk is worth taking. In my opinion, all portfolios should be built to produce positive alpha, regardless of whether they are considered aggressive, conservative or anywhere in between.

Compounding: It seems everyone is focusing on average annual returns as a benchmark, but I think they're looking at the wrong number. Don't just look at the rate your investment averages, look at the rate your investment compounds. I believe that's a more telling number. As Albert Einstein once said, "The most powerful force in the universe is compound interest."

Worst-Case Scenario: I encourage you to look at the investment's historical performance and examine its worst period, not just the best. I believe if you can accept the worst, the rest should be acceptable as well. If you are considering several investments, look at each option's best-case and worst-case scenarios. I believe the most appropriate option will generally be the one with the best worst-case scenario.

Time Horizon: How long do you have until you'll need your money? If you're a long-term investor, then allowing a little more risk might make sense--as long as you have greater potential for long-term gains. But if you are hoping to retire soon or fund your teen's Harvard education, you may want to consider something less risky.

Diversify: If you want to reduce the overall risk potential in your portfolio, consider options beyond just the stock market. Alternative investments, while not appropriate for everyone, may help you be more absolute return-oriented and not solely dependent on the stock or bond market. Diversifying with alternative investments has been a successful strategy for some large institutions for years, but many individual investors haven't yet realized they can employ this strategy for themselves.

Sound Advice: It helps to have a trusted financial adviser that understands and believes in the importance of managing risk. You might be surprised at how many think risk is just a necessary evil. And choosing an experienced adviser can give you access to investment strategies and opportunities you may not be able to access on your own.

While it's impossible to eliminate risk entirely, it is possible to take steps to help minimize the risk in your portfolio by paying close attention to it on the front end and investing wisely. I believe it is crucial to understand that not understanding your level of risk is the biggest risk of all.

Tony Christensen is president at ACCESS Wealth Management in Louisville, Ky. Investment products and services are offered through Wells Fargo Advisors Financial Network, LLC, Member SIPC. ACCESS Wealth Management is a separate entity from WFAFN.