Understanding Risk & Reward

One of the most important tenets of financial planning is to understand a client's attitude to risk and then to ensure that any investment advice is aligned to that risk.

In his book, The Psychology of Money, Morgan Housel states that, **"To get wealthy one must stay wealthy. No one wants to hold cash during a bull market, they want to own assets that go up a lot. Holding cash during this period makes you acutely aware of how much return you are giving up by not being in the stock market. But if that cash prevents you from having to sell your shares either during a rising or falling market, the actual return on your cash could be worth many times the interest earned, because preventing one ill timed stock sale can do more for your lifetime returns than picking dozens of big winners."**

Not having to sell shares means more time spent in the market which will help to compound returns. Compounding doesn't rely on earning big returns; merely good returns sustained uninterrupted for the longest period of time. It was Charlie Munger, Warren Buffett's long time business partner, who said, **"The first rule of compounding: Never interrupt it unnecessarily."**

So, what do we mean when we discuss a client's attitude to investment risk. Typically, the standard document handed to clients refers to five levels, from Low to Low-Medium, through to Medium and then onto Upper-Medium and finally High, with the majority of client's sitting within the comfortable Medium category. But whilst there will be very wealthy clients who are willing to take higher risks due to their greater capacity for loss, there are equally others as rich who take the approach of wanting to simply stay wealthy and are content with steady returns.

However, I do not think such documents accurately explain what we mean by attitude to risk. I have described above the importance of retaining sufficient cash reserves to meet near term commitments and not to have to sell investments at the wrong time. But there is another equally important reason and that's to make sure you have enough in cash on deposit to make you feel safe and comfortable. This is known as **Opportunity Cost**.

Spreading your investment over several companies helps reduce risk. Its unlikely you will lose all your money if you invest into several companies as all of them would have to fail to do so. Risk in this context means loss. On the other hand over diversification reduces returns, so there is a balance to be had. Investing over different asset classes is designed to produce negative correlation which means that if one asset class falls, another may rise or at least hold steady. But in really stressed markets all asset classes can move in the same way. And whilst history has shown us that some assets, such as shares go up more than they go down and that markets can rebound rapidly after a crash, they can also take a while to recover.

What is a certainty is that investors will experience volatility which, whilst unpleasant, is simply the price for generating superior returns. It is the cost of admission to doing well over time. How much volatility any one investor wishes to bear to achieve superior returns over time comes down to the **'Opportunity Cost'** of so doing. It means the potential of foregone profit from a missed opportunity.

Robert E. Rubin, a former US Treasury secretary and co-senior partner at Goldman Sachs and board member of Citigroup wrote recently on the subject under the heading **'Risk as a Range'** in his book The Yellow Pad. "**Even in good times, I am likely to have a somewhat greater percentage of my assets in cash, where there is no possibility of a significant gain if markets do well, but also no possibility of a significant loss if they don't. In other words, I am paying an opportunity cost to lose less in the possible circumstance, however remote, that severe outcomes occur. Whether I'm better off or worse in the long run, I don't know. But I feel more comfortable this way. For me, the benefits, in the form or reduced risk, outweigh the costs."**

Understanding the Opportunity Cost for each client is the basis of any investment strategy we create for them.