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Wear Your Helmet

Minimizing Risks Without Reducing Returns

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Most scenarios in life in which a reward is promised involve some element of risk. A football player with a contract paying him $500,000 a year has to weigh the monetary reward against the risk of being injured. He reduces the risk of injury by wearing protective equipment and by training his body to respond effectively and efficiently to threats and opportunities during the game. If he decided to play without a helmet or reduced the padding he wore, he would significantly increase his risk of injury without increasing his expected reward from the contract.

In the world of investing, protecting yourself against taking the kinds of risk which will not be rewarded involves three basic approaches:

Smart Diversification

Asset Allocation

Reducing Costs

Although diversification does not eliminate the risk of market loss, it reduces the impact of the performance of any one company, market or mutual fund on an investment portfolio. Investors focusing their portfolio on a few select securities in an effort to own the right stock are akin to the player taking his helmet off to play - significantly increased risk with no expected increase in return. An efficient portfolio should be diversified by geography (international as well as domestic markets), by economic sector (such as health or finance), size of stock (small cap versus large cap), and other factors to spread the risk. A well-diversified portfolio can provide the opportunity for a more stable outcome than a single security.

Some would argue that diversification will make an investor miss out on the potential rewards of backing the next Apple or Google, because a significant portion of the invested assets are not invested in one potential “winner”. Warren Buffett agrees, but he says, “If you are not a professional investor … then I believe in extreme diversification… maybe more than 99% of people who invest should extensively diversify.”*

The challenge of asset allocation is to build a portfolio with the right mix of stocks, bonds, cash and other investments that will achieve a targeted return while minimizing anxiety. Asset allocation must be aligned to specific goals and objectives. For example, an investor that has recently retired and is drawing retirement income from a portfolio should likely be pursuing an asset allocation strategy with a higher weighting in fixed income investments while a younger investor pursuing growth would likely assume more risk and emphasize stocks. These financial goals and the asset mix selected to achieve them should be spelled out in a document or an Investment Policy Statement (IPS).

The costs of investing—the fee structure of mutual funds, expense ratio, sales commissions, and trading costs—can seriously erode portfolio returns. Attention should be paid to reducing expenses and stock turnover within the portfolio. While costs are a factor in why investors achieve lower returns than the market as a whole, investor behavior is surely the largest factor.

We are our own worst enemies

In this summary we have discussed various biases and the resulting behaviors that work against us: the equivalent of a football player playing without his helmet. As Benjamin Graham observes in his book The Intelligent Investor, “The investor’s chief problem—and even his worst enemy—is likely to be himself.”*

Markets are volatile and can periodically behave irrationally. However, investors that maintain a well-diversified investment portfolio using asset allocation principles and focusing on low costs should take comfort in staying the course when temporary disruptions do occur.

** Past performance is no guarantee of future results. This information is intended to be educational and is not tailored to the investment needs of any specific investor. Excerpts of this material were taken from Assante Capital Management Ltd., Toronto, Canada. Warren Buffett quote: Discussion with MBA students, Capella University, 2018; The Intelligent Investor: Harper & Row Publishers, Inc. 1949, 1973 edition: HarperBusiness Essentials, ISBN: 0-06-055566-1.* *2020.05.21 JJ*