RIVERFRONT INVESTMENT GROUP

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THE WEEKLY VIEW

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- **We think this is a good time to reassess your goals and risk tolerance objectively.**
- **We believe risk means different things to different investors at various stages of their investing lifecycle.**
- **We examine six different types of risk with advice on handling each one.**

Rebalancing and Risk Tolerance

A GREAT TIME FOR A CHECK-UP

After a banner year like 2019, with the US stock market near all-time highs and most major market regions close to one-year highs, we think this is a good time to reassess goals and risk tolerances objectively. The rationale is not related to our outlook for 2020, which calls for another positive year for global stocks. Rather it is part of the prudent process of planning, which in our view is about understanding different types of risk and your personal tolerance for these risks.

We believe risk means different things to different investors at the various stages of their investing lifecycle. For example, an investor in or close to retirement must weigh the risk of a fall in the value of their portfolio (losing money/volatility) against the risk of generating insufficient income and capital appreciation to offset inflation (inflation risk). By contrast, we think an investor with decades until they expect to need their money should worry less about swings in the value of their investments and focus more on saving and investing regularly and thus buying at a variety of different market levels. We believe the greatest risk for this investor is not short-term volatility, or bull and bear markets, but rather failing to start saving at an early age and/or failing to save enough of their income. This means they miss out on the opportunity to take advantage of the amount of time they have and thus of the power of compounding.

DIFFERENT TYPES OF RISK

Losing Money: This is the answer that most of our clients give when asked about risk, but we think it is critical to ask, "over what timeframe?" While the stock market does rise on average roughly two-thirds of the time we are not aware of anyone who has successfully predicted the markets' direction every year. Thus, we advise investors who cannot afford to lose money over the coming 12 months to avoid stocks and other risky assets. At RiverFront, along with many financial advisors, we have focused this discussion about risk on the probability of losing money over longer time frames. We have also introduced two concepts: 1. Price Matters®, which recognizes that the starting price can affect 5 and 10-year returns if it is at an extreme by historical standards and 2. Yield Matters, which identifies the starting yield on bonds as the biggest influence on future returns.

There is an important distinction between 'needing the money' and 'thinking you will need the money' and for that reason it is important not to conflate events (retirement, college, etc.) with investment time horizons, in our view. For example, many investors think of their retirement as the goal, but it is just the beginning of a withdrawal phase. As average life expectancies increase, so does the time-horizon for investors. In five and ten-year timeframes, we think stocks will deliver higher returns than bonds or cash in a low interest rate environment, so long as stocks are not at optimistic extremes. **In conclusion, we seek to design portfolios for time horizons between three and ten-years using strategic combinations of stocks and bonds, seeking to make tactical adjustments along the way.**

Volatility & Headline Risk: The classic definition of volatility is the standard deviation of returns (a concept familiar to someone who has studied statistics). For those who have not, standard deviation is a measure of the magnitude of price swings. **Price volatility**

can create emotional volatility, and the emotional response to swings in asset prices can cause investors to make poor long-term decisions. We believe investors plan in five and ten-year horizons but can react to sharp price declines without waiting for their plan to play out. Let's call that emotional risk.

To use an extreme example: In the autumn of 2008 stock prices fell dramatically in response to a severe financial crisis which led (as many expected) to a major economic downturn. Investors reacted differently over the coming months. Some watched their nest-egg evaporate before their eyes and chose to cut their losses. Others saw a long-term opportunity to buy and were willing to be patient. A lot depended on their circumstances, but emotions played a significant role. In our view, the long-term psychological effect of the 2008 market decline is still influencing many investors and has caused them to be cautious for much of the 10-year bull market in stocks. A recent example of headline risk would be the coronavirus outbreak which has caused stocks to fall, but we think should not influence long-term plans. We believe that while events such as the coronavirus can have a short-term impact on asset prices, their long-term impact is minimal.

The 'Frozen Investor' Risk: This is something we encounter frequently and referred to it as 'altitude sickness' in RiverFront's *Outlook 2020*. For example, an investor who has a significant portion of their assets in cash and wants to buy stocks but is frozen into doing nothing by the fear that they will get the timing wrong. Paralysis can also be exacerbated by the geo-political climate, making it easy to put-off investment decisions until the 'clouds clear.' We understand this emotion well since market timing is something we have already said is, at best, extremely hard. **Our advice is to use a dollar cost averaging strategy, building up to the desired amount in tranches over time.** We think the key is to get started, recognizing that if the market rises after the initial tranche then the investor is starting to make money. If it falls, then subsequent investments can potentially take advantage of lower prices.

Insufficient Savings Risk: This risk relates to those who find themselves in the position of not having saved enough. In this event you can either cut back on your spending or seek to generate a higher return (or a combination of both). The investor has already put themselves at risk through insufficient savings. We suggest that adding more risk is not a prudent thing to do, and yet many do. Yes, you can be lucky, but in our view, luck alone is not a strategy.

Inflation Risk: In assessing risk, we believe it is important to take account of inflation. Investors can preserve their initial portfolio value by simply owning cash. However, if cash, such as bank savings accounts, 3-month Treasury bills, or money market funds, yield less than the rate of inflation, they are losing purchasing power, and thus losing money, net of inflation. This may necessitate a higher allocation to stocks, which generally speaking have beaten inflation over time. Thus, for many investors the prospect of inflation beating returns is not a luxury, but rather a necessity for their portfolios to accommodate their long-term goals**. In other words, ignoring inflation risk over a period of time can create a future dilemma where long-term goals will need to be adjusted down, or an investor is forced to take out-sized risks to 'catch-up.'** We believe this risk is often under-appreciated.

The Young Saver's Risk: The power of compounding, and the value of starting to save as soon as possible. We believe a good general investment guide is to save 10% of income and to start as soon as you have income. Not everyone can do this, but the power of time and compounding returns can be dramatic. The US Securities and Exchange Commission (SEC) has a website called Investor.gov[1]. On the website is a compound interest rate calculator. The inputs are: the initial investment, the monthly contribution, the length of time you plan to save, the interest rate, and the compound frequency (from daily to annually). Purely by way of example, we used the same inputs for two savers A and B, the only difference was the number of years of saving. For both investors we started with an initial investment of $1000, a monthly contribution of $100, an interest rate of 5% and we compounded annually. Investor A did this for 40 years, investor B for 20 years. Investor A contributed $49,000 and had $151,999.72 at the end of 40 years, Investor B contributed $25,000 and a total value of $42,332.44 at the end of 20 years. Investor A ended with 3.1x their investment, investor B 1.7x. We strongly recommend visiting the site, especially if you are just starting on your investing journey.

You will find that as you increase the savings rate, the rate of interest, and the frequency of compounding, the difference in the final amount rises exponentially. These examples are hypothetical, and we recognize that interest rates or rates or return are not guaranteed, and all investing carries a risk of loss. Nonetheless, we believe

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compounding is simply mathematics. Richard Russell wrote in a book called *Just One Thing,* “To compound successfully you need perseverance… intelligence… knowledge… and time.” We agree.

REGULAR REBALANCING IS CONSIDERED ‘BEST PRACTICE’ BY MANY ADVISORS.

Following a year like 2019, institutional pension funds will likely be rebalancing their portfolios towards their agreed long-term benchmarks and looking at their liabilities to ensure those benchmarks remain appropriate. This will likely have nothing to do with their 1-3-year outlook for markets. While individuals and couples only aged by one year, one could argue that they achieved several years of expected returns during 2019. The implications of 2019 for those close to, or in retirement is more significant, in our view. We believe that those who are no longer adding to their retirement portfolio or those who are withdrawing money in retirement, should be especially focused on potential rebalancing opportunities. Thus, we believe this is a good time to have a discussion with your financial advisor to reassess and confirm your strategy.

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In a rising interest rate environment, the value of fixed-income securities generally declines.

Stocks represent partial ownership of a corporation. If the corporation does well, its value increases, and investors share in the appreciation. However, if it goes bankrupt, or performs poorly, investors can lose their entire initial investment (i.e., the stock price can go to zero). Bonds represent a loan made by an investor to a corporation or government. As such, the investor gets a guaranteed interest rate for a specific period of time and expects to get their original investment back at the end of that time period, along with the interest earned. Investment risk is repayment of the principal (amount invested). In the event of a bankruptcy or other corporate disruption, bonds are senior to stocks. Investors should be aware of these differences prior to investing.

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