Another Perspective on the Risks of Common Stock Investing

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There are important factors to consider when assessing the risks associated with investing in common stocks. Recently, we have seen an increase in the number of warnings about how an investor should evaluate the risks of investing in the stock market. Unfortunately, most of these recommendations focus on one specific measure: price volatility. Products that provide a measure of volatility as the primary benchmark of making an investment decision leave a lot to be desired. The reason is that, given certain basic investment tenets, such short-term measures of price instability are worse than useless for making long-term investment decisions. In examining the long-term returns of various market indices where diversification minimizes just about all risks except market risk, an investor can see that time reduces, if not eliminates, the risk of losing money. Our studies indicate that a well-diversified, indexed portfolio of equity securities such as the S&P 500 can reduce the probability of losing money. Our studies (available on request) are based on the historical returns of that index since 1926. When we have diversified a portfolio among various market capitalizations and styles, that probability of loss can be reduced even further. When a portfolio moves away from this basic theory of diversification, then other risks can have a dramatic impact. The following real-life example should bring home the idea that price volatility is only a minor part of the overall risk equation. (Note that this is not a story related to Victoria Capital but to another investment firm.)

In mid-2008, an investment analyst identified erratic behavior in one of the mutual funds that was held in multiple asset allocation portfolios. The problem was that the fund's performance was moving both strongly to the upside and downside relative to similar funds in the same universe. The mutual fund company was contacted, and the spokesman explained that the focus of the investment team was on returns and intimated that some additional risk was being taken to achieve these higher returns. The investment team noted that individual mortgage-backed securities were being utilized to add alpha to the fund and that derivatives were also being used to pump up performance. What a red flag!

The fund was removed from all eligible portfolios in a disciplined manner within 30 days since the investment team was utilizing strategies not outlined in the investment objective of the fund. This risk demonstrates a classic case of portfolio managers gone awry. While none of the rating agencies (including Morningstar) picked up on this risk, clients in the portfolios were not negatively affected given the fact that the fund was sold. Nevertheless, this fund declined nearly 80% by November of 2008 clearly demonstrating that such a bet on mortgage-backed securities and derivatives went extremely wrong. The rating agencies did not downgrade this fund until sometime in 2009. The point is that the price volatility of a security is not the only measure of risk. One must be vigilant in analyzing all potential risks of an investment and remember to focus on the long-term benefits versus short-term price volatility.