Reprint from Yardley News, September 2014

The Inevitability of Risk and Investing

If you want significant reward, you will have to assume some risk. Anyone investing in securities – particularly stocks and funds – must accept that reality. Investing in the markets gives you an opportunity to accelerate the growth of your savings and outpace inflation, and you definitely want that chance – but how do you cope with the risks linked to it?

Here are the four varieties of investing risk – and tactics that may help you manage or counteract them.

Diversification & concentration risk. This occurs when a portfolio isn't varied enough. Some investors have everything in a handful of stocks or a couple of funds representing just one or two "hot" market sectors. If macroeconomic factors hurt those companies or industries, that undiversified portfolio may suffer a major setback. Even a bad earnings season may do significant damage.

Tactic: Diversify across asset classes, moving money into funds that provide broader market exposure. Avoid a glut of holdings in a given sector – even a sector everyone insists is "hot." The flavor of the month can sour next month. Broad diversification gives investors a chance to capture gains in different market climates, and sets them up for less pain if a particular sector or asset class dives.

Reinvestment & timing risk. All investors would like to buy low and sell high, but some succumb to impatience and leap in and out of the market. In attempting to time the market, they end up hurting the long-range performance of their portfolios. The weakness of buying high and selling low has caused too many investors to miss the best market days. Besides that, bond investors commonly face reinvestment risk – the hazard that a bond's coupon will end up reinvested someday in a lower-yielding security.

With regard to stocks, here are some long-term statistics worth noting. Standard & Poor's reported research (Standard and Poors.com/May 5, 2014) that if a hypothetical investor had simply parked $10,000 in an index fund mimicking the S&P 500 on January 1, 1994 and just watched it for 20 years, he or she would have wound up with $58,350 at the end of 2013. If the same investor was out of the market for just five of the top-performing days during those 20 years, he or she would have amassed only $38,723. Investment research firm DALBAR estimates that from 1991-2010, the average mutual fund investor earned 3.8% a year compared to an average 9.1% annual return for the S&P – and that 5.3% difference no doubt relates to buying high and selling low.

Tactic: Instead of jockeying in and out of stocks and funds, buy and hold while scheduling consistent income through bond laddering. Use dollar cost averaging to pick up more shares of quality companies in down markets, with anticipation that they will be worth more in better times. Employ tax loss harvesting: harvest losses to offset capital gains, with the objective of bettering the after-tax return of your taxable investments.

Credit quality, interest rate & inflation risk. As you invest in the bond market, these three risks must be watched. A corporate bond's rating (credit quality) may be downgraded by S&P or Moody's, for example, implying a greater default risk for the bond issuer and signaling less certainly that you'll redeem all coupons and principal. Interest rates can climb, sending bond prices south. Rising inflation can turn a bond that seemed like a "can't lose" investment years ago into a loser at the date of maturity.

Tactic: Use individual bond issues in a laddered strategy and/or target maturity bond funds; think about zero-coupon or revenue muni bonds, or explore hybrids like preferred securities or structured notes.

General market risk. Anyone with a foot in the markets must recognize systemic risk – the potential that many or all market sectors may be riled by shocks such as a geopolitical crisis, an act of terrorism, a recession or a natural disaster. How do you cope with that?

Tactic: If you hold stocks that have logged significant gains, consider adopting a collar strategy for them – that is, writing a call option and purchasing a put option on equivalent shares. This move essentially gives you a covered call *and* a protective put and targets two exit prices for the underlying stock. Collars can be highly useful when volatility strikes Wall Street, and they may let you hedge positions in certain funds when conditions turn bearish. In the bigger picture, you could look into a core-and-satellite approach to investing: passively managed investments at the core of a portfolio, actively managed investments as the "satellites" seeking greater returns in different market climates under the guidance of a skilled money manager.

By Loretta Hutchinson, CFP®, CDFA™
InSync Financial Group, info@insyncfg.com, ph. 215-302-3437