By Jerry Verseput, CFP®

A Different Way to Think About Risk

The last decade has brought the concept of risk into sharp focus for many investors. Investors have learned that advisors and TV experts really don't know what's going to happen in the next week, the next year, or the next decade. After 13 years of the S&P 500 flailing around and essentially treading water, many investors are beginning to question whether the market is really safe, even if they're in it "for the long-term."

In my practice, I'm finding that clients continue to need a reasonable rate of return to meet their financial goals, but they have lost their tolerance for losses. Perhaps it's due to the number of "the world is ending so buy gold" commercials on the radio, or maybe it's that the 24-hour news cycle tends to highlight every global economic hiccup as if the latest crisis is the one that's going to bring about the Mad Max world we've all been dreading.

> The effective after-tax savings (i.e., return) of paying down a mortgage is higher than that of a 10-year Treasury, and it's even safer. However, to get the higher return, something has to be given up. That something is liquidity.

In any case, explaining to clients that exposure to equities involves market risk, and that market risk means the possibility of losing money, doesn't always seem to take hold. I think that too many people for too long, including advisors, accepted the idea that the stock market is a 10-percent cash machine as long as they are willing to ride out the dips and stay in for the long-term. Many have now stayed in for what they thought was the long-term (10+ years) and are wondering why they haven't seen their investments double.

The risk-of-loss disclaimer at the bottom of the investment policy statement page seems to be about as effective as the warning on your cold medicine that it can cause nausea, convulsions, and growth of an extra limb. It's just not real until you realize you need a third shoe.

Risk as "Returns Tradeoff"

I've started to think about and explain risk to clients in a way that may make it more intuitive. In a nutshell, it's been helpful to think of risk as a tradeoff.

I start with the standard risk-free rate of return. Normally that would be the yield of a three-month Treasury bill, but for investment purposes I'll assume a 10-year Treasury. As of this writing, that would be a safe and reliable 2-percent return, but with headline inflation running above 3 percent, a risk-free investment today will probably result in less buying power in 10 years. That's unlikely to allow most investors to reach their financial goals. Therefore, if we want more return than the risk-free rate, we need to make a tradeoff between the safety of a Treasury and something else.

The obvious tradeoff if you stick with bonds is to trade the risk of default for added return. By adding bonds that have a higher chance of default, we make a tradeoff between the safety of Treasuries at a low yield for the risk of default and a higher yield.

If that's not enough, we can trade market risk for return and move into stocks. In this case, the tradeoff is between the safety of Treasuries and exposure to the ups and downs of the market for the hope of a higher return.

By thinking of risk in this way, clients are able to understand that they are giving something up (safety) in order to get something else (higher return), which puts them more in control of their decisions.

Risk as "Liquidity Tradeoff"

For many investors, this is where the tradeoff choices end. However, there are other things that can be traded that may produce the required return with greater reliability and a reduced risk of loss.

For purposes of this article, I'm going to look at liquidity as a tradeoff. Paying off a home mortgage is an example of a liquidity-for-return tradeoff. The effective after-tax savings (i.e., return) of paying down a mortgage is higher than that of a 10-year Treasury, and it's even safer. However, to get the higher return, something has to be given up. That something is liquidity. After a mortgage payment has been made, there is no way to get that money back, except for taking out another loan. We should think of the "investment" of paying down a mortgage as completely illiquid.

Now, what about investments that actually make money? Two alternative funds that I like to use are SQN Alternative Investment Fund (equipment leasing) and AmeriFunds Secured Income Fund (mortgage notes). *(Editor's note: SQN and AmeriFunds are NAPFA Resource Partners and advertisers in the* Advisor.*)*

Both of these funds generate income that is secured by real property. In the case of SQN, the property might be an MRI machine or something really sexy like storage containers. For AmeriFunds, the income stream is secured by real estate notes. Both of these funds have either preferred returns or expected annual yields in the neighborhood of 8 percent, are non-correlated to the stock market, and have extremely low volatility.

Obviously, these are not risk-free investments. But because they hold tangible assets, I would argue that they have less risk of loss than owning direct exposure to the stock market. The tradeoff to get a more reliable rate of return is liquidity. Although both funds will redeem shares on a best-effort basis, which makes them more liquid than paying down a mortgage, they might levy a penalty if a client's money is needed within the first few years after making the investment, or it may take several months before shares are redeemed if there is a high demand for redemptions at that time. These features make these funds and others like them inappropriate for short-term holdings of less than four to 10 years, depending on the fund. However, for a limited portion of a portfolio that doesn't require liquidity, most of my clients would rather trade liquidity in order to achieve an 8-percent return than, say, purchase a junk bond that yields 8 percent.

I realize that every client is different and every advisor's style is different, so I'm not claiming that this is the best way to think about risk. However, I've found that many of my clients seem to grasp the concept of risk and why we're taking it when they think of trading either safety or liquidity in order to get a higher rate of return than the risk-free rate.

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