

Risk

by Gail Vaz-Oxlade

Tumultuous. The word brings to mind passengers scurrying to safety to avoid the crash of an angry ocean, or the sinking stomach experienced in an airplane tossed by turbulence. It is also a favorite word used when describing the stock market, it's wild and crazy ride to the stratosphere and down again, and the emotions of investors as they are carried along for the ride, often unwillingly. When boarding that plane or boat, most passengers give little consideration to the risks they are taking. Most pay little heed to the safety demonstrations, warnings, and signs offered, just in case. Ditto investors. For while investment risk – and its natural counterpart: diversification – are standard phrases in the financial lexicon, investors are often reluctant to listen to the warnings, follow the demonstrations or recognize the signs that indicate a wild ride.

What is it about us as human beings that makes us willing to assume a little or a lot of risk? And how exactly does one define such a nebulous word anyway, since what's risky for one cat may not seem in the least bit risky for another. Risk can be defined as the potential for loss. It could be loss of capital; it could be loss of purchasing power or the loss of sleep. Some people think its kind of macho at a party to stand up and say, 'I'm a high-risk taker.'

Macho eh? Well at least part of it is in our genes, or so it would seem from the research done by the new kids on the block: the experts who study behavioural finance.

The Genetic Factor

Women are less tolerant of risk than men. Yep, it's true. Now, before you go getting your topknot in a twist, this isn't gender bias. And it isn't all bad news.

In his book, *Galen's Prophecy*, Jerome Kagan cites epidemiological surveys that indicate a greater female susceptibility to a fear state. (Kagan is a professor of psychology at Harvard University whose research on the cognitive and emotional development of a child during the first decade of life focuses on the origins of temperament.) Kagan suggests that man's socialization as a hunter and his need to face fear regularly has biologically reduced his negative reaction to fear. Women, socialized as gatherers, had less exposure to the fear factor and so continue to react more strongly to fear. The result: girls are, at every age, more fearful than boys. According to Kagan's studies, "among the distressed infants who showed high fear at both fourteen and twenty-one months, 86 percent were girls." Note the ages here. These are toddlers who have yet to suffer the vagaries of modern-day socialization.

Even though it may be true that men are willing to take more risk, it doesn't mean that men are doing better because it doesn't mean that they're taking efficient risk, as economists like to talk about the risk/return relationship. That's supported by yet another body of research that has come to light through the analysis of Terrance Odean, assistant professor at the Graduate School of Management at the University of California, Davis. Odean refers to the difference in male and female investment patterns as follows: Men churn, women earn. Odean who has done detailed studies of investors' trading patterns suggests that it is men's overconfidence in their skills as

investors that lead to under-performing portfolios. Over-trading is one of the most certain ways to generate negative return increments.

Risk and Perception

What about our ability to delude ourselves into a risk profile that's too high, or underestimate our ability to handle risk because, well, we've always perceive ourselves to be chicken.

People can be perverse. Witness when psychologists interviewed a tightrope walker to understand how he handled risk and the guy looked at them and said 'I don't take risk. Everything I do is very controlled and I know what I'm doing.' From any "normal" person's point of view he isn't correct. He hasn't perceived properly the risk that he's taking. By any objective standard he's taking a lot of risk.

Risk tolerance in a financial sense is very similar to risk tolerance in a physical sense. Those who will jump off tall towers with large elastic bands tied to their feet may also be willing to leap into roller-coaster stocks.

So, it would appear that some people take risks because they don't understand that they are taking risk. Or, perhaps, it is because they face extreme risk over and over that they develop a higher tolerance — almost numbness — to risk. The opposite is also true. People who are very afraid think they are taking more risk than they actually are. What's the answer? According to most people in the know, it's a score card by which we can match the risk profile uncovered through clever questioning against a portfolio that perfectly reflects our risk tolerance.

Recency is Hard-wired

People are actually hardwired to over-react to recent events. This works if you're a forager. If you're looking for food the best place to look is where an animal was yesterday. So recent events are good predictors of what will happen today.

Often when people are successful, that increases their tolerance for risk. Having earned big money, they consider themselves now to be playing with 'The House's money'.

The market cycle will also influence people's risk-taking inclination beyond what their innate inclination is. It seems that no matter how much the experts talk about market cycles, investors cling to the idea, ill formed, that wherever we are today in the markets, that's where we'll stay. So if we're in a rising market, the market will continue to soar, and as we have experience most recently, a downturn in the cycle can make people run screaming for the exits.

People buy funds that earn 50, 60 or 70 percent returns up to the point at which they buy them and imagine that they have found a secret formula that produces return at no or limited risk. What they don't realize is that by buying a very high performing fund they are guaranteeing themselves a very risky investment.

If those in the know had their way, we'd all dollar-cost-average into a pool of investments that most closely matched our tolerance for risk, while providing a healthy — but often far from spectacular — rate of return. We'd all be tortoises.

An Optimist's Illusion

Optimism plays a big part in how invincible investors feel. Two finance professors have done research to show that price movements on stock markets are considerably greater on sunny days, and that's blowing people mind.

There is no predictability for the factors that are going to influence the market. This, of course, is why the pundits all take the position that you must be a long-term investors because that's the only way you can ever cope with the market's shenanigans. But there are always investors out there who are unwilling to settle for good enough. They want spectacular. People believe that if they work very hard at studying companies and mutual funds, at looking at screens and looking at data, they're going to do better than average. It's a fundamental human condition.

Why? People don't like the idea that there's randomness in their lives. They are determined to maintain their illusion of control. People want to believe that the things happening around them are to some degree influenceable by the application of rationality. And it just isn't the case in the stock market. But it is an illusion that is very hard to give up

Nothing about the world of investing says that investing off our gut is a sensible thing to do. So why do investors keep doing it? There's another inclination that has also been documented and it is that people like a long shot. It makes life more exciting. If you have a craving for an extremely large return, even though it has a very low probability of occurring, you'll overweight it's important and take the risk.

Risk and Regret

Regret is one measure against which to measure risk. Because risk is relative, it's hard to quantify. Volatility doesn't really capture it. Need an example? Let's take the person who is retiring and who wants to sell his house. Along comes someone who says take it or leave it but tell me in a day. It's a low offer, but if you turn it down and can't sell you'll really regret it. However, there is also the possibility that tomorrow another much higher offer could come and you would regret not having waited. Which has the least regret?" Once you figure that out you know what path to take.

Risk, of course, isn't simply an emotional issue. If it were, as investors we would be left to the vagaries of our emotional spectrum without any weight given to the role of our intellect, experience and wisdom can play in helping us better understand why we take the risks we do.

Take for example the scenario many investors faced having watched stocks like Nortel or BreX rise dramatically. Their realized regret at not having participated in the glory and riches of these stocks outweighed any potential regret they might experience in term of the risk to their capital. It's been long accepted in the area of behavioural finance that an actual loss hurts more than an opportunity loss. But what if the actual loss is recognition (for being smart), connectedness (to belong to the groups of investors playing), and ego (see, I am smart!) and the potential loss is our

sweat-stained money? Then regret could work against us, while the intelligent application of a sound risk profile might keep us on the straight and narrow.

“Anchoring” may be one explanation for consumers’ willingness to leap into a declining stock. People saw the stock had been at \$20 or \$30 before, it went to \$120 and they were anchored in this range. So the middle of the range seems like quite a reasonable place to be. Once the stock passed the middle mark on its way down, investors decided that Nortel was a good buy. The question then was this: Is \$65 a ridiculous overvaluation of Nortel or was it ridiculously undervalued? Time told the story.

So do investors have to give up all the fun of playing the market? Not at all. As long as you are not risking a significant part of your holdings then it’s great. Assigning ten percent of your portfolio to active, speculative investment, would not only give us the thrills we’re seeking as investors, it would distract us from the vigilant watchfulness of our remaining portfolio which could then grow in peace.

Investment Horizon

While economists look very far into the future and very far into the past, investors have a hard time doing both. We have very high personal discounting. If it’s doing very badly now, and it’s going to do very badly for the next two years, let’s get out. We end up making decisions on a short- and medium-term basis, instead of using a long-term investment horizon. Our psychology makes it very hard for us to be good investors because we over-react to recent events, we narrow our investment horizon. The answer then is to match one’s investment risk profile to a well-diversified and efficient portfolio and forget about it.

That doesn’t mean abandoning your oversight responsibilities. You need to make sure that for the level of risk your manager is taking over longish periods of time that manager has produced rates of return that are appropriate. Make sure you’re measuring your fund, or any prospective investment, against the appropriate benchmarks. In the case of mutual funds, it means looking at year-over-year returns over five or more years to identify volatility, and comparing apples with apples when it comes to the portfolio make-up, style and geographic orientation.

Diversification is Boring

When you’re preaching diversification and asset allocation as a risk management strategy, and one sector of the market is taking off at 60+ percent return, no one cares much for what you have to say. During the last bull market, people thought they were being penalized by following good investment advice.

The concept of diversification has been around for a long time, perhaps so long that we’ve become unwilling to stick with such an ‘old fashioned’ idea. After all, if diversification is the answer to risk, one has to wonder why people don’t just do it. People don’t want to hear it. People want to have fun. They want to go for the long shots. And that’s fine, as long as they understand the risk that they are taking. However, for those people who refuse to accept that risk is involved, who don’t look at the downside before making the decision to jump in, disappointment lies ahead.

Even when a stock or fund seems to have a medium-term successful run, three or four years of heady growth, that doesn't mean all's well and it's time to jump in. Just the opposite may be true, in fact. Economists looking at that pattern look at mean reversion, referring to the fact that the price of the investment will fall to where it should have been, while an investor looking at the same pattern sees a predictor of future growth.

The most difficult part of dealing with risk may be coming to terms with our tendency to work against our own best interests. Whether it is over-confidence, optimism or machismo, we're very happy to work extra hard to lose more money. For if we took the long-term horizon preached, if we laid a plan and stayed the course, if we stayed true to our risk personality, we could be wealthy with a lot less effort. Maybe all we need do is give diversification a catchy new nomenclature to make it a little sexier. Then, perhaps, we'd heed the good advice that abounds and take only the risk for which we were most prepared.

DIVERSIFICATION

Diversification refers to buying a mix of investments that reduce risk because when one investment type isn't doing particularly well, another will pull the whole portfolio along very nicely, thank you. Whether you call it "asset mix," "investment mix" or "asset allocation," it's the same thing. To effectively diversify, not only do you have to buy assets within different classes (i.e., some equities, some bonds, etc.), even within asset class you must mix the investments held.

So within the equity component of a portfolio, you should hold stocks of different companies, those companies should be in different industries and in different countries.

Here are six ways to diversify a portfolio:

- by the types of investments — using bonds, deposits, stocks, mutual funds and real estate
- by the quality of the investments — the lower the quality the higher the return offered to offset the higher potential for loss
- by region (in Canada, North America, globally)
- by currency
- by levels of liquidity — holding some long-term deposits such as stripped bonds or equity funds, along with some shorter-term investments such as treasury bills, and
- by manager's style, when the investment portfolio is made up of mutual funds.