

Chapter 2

Risks

In finance and investment, risk is the likelihood of losing money. Warren Buffett, one of the most successful investors in history, claims he lives by two principles: (1) do not lose money; and (2) do not forget the first principle. Unfortunately, this is easier said than done. Many dangers confront investors. We will discuss the most serious of them so that everyone understands at the outset that investment is not a totally benign activity. We begin our tour of risk with economic risk.

2.1 Economic Risk

Investors are generally well served by an economy that simply hums along. During bad times, inflation and high interest rates cut bond prices. And depressed conditions can hurt stock prices, curtail company profits, and trigger a cascade of damage. A tragic example, the great depression of the 1930s, comes to mind. The cause: “margin debt” on stocks. Margin debt occurs when investors pay only a portion of a stock’s price from their own pockets and borrow the rest from brokerages. In 1929 as stocks declined, this debt became unpayable.

More recently our current depressed economy began its downward slope in 2007. Investment banks securitized mortgage debt by aggregating thousands of mortgages into bonds. This period, too, has seen market price declines and high unemployment. Although firms have record amounts of available cash, they have refrained from investing in new equipment or new employees because they are wary of the economy. In a June 2011 survey by TD Ameritrade, 55% of baby boomers said they would retire later than they had originally planned and 17% said they needed to support their adult children or other relatives (*Enlightened Investor*, Fall 2011). As far as individual investors are concerned, during these challenging times, one must safeguard one’s resources. Buy safe bond funds and buy stocks of firms that do well in difficult economies, e.g., Wal-Mart and McDonalds are two financially healthy choices.

2.2 Market Risk

In the first 10 years of the twenty-first century, the stock market declined dramatically more than in any decade since equity and bond trading began in 1830 under the buttonwood tree in New York City. The market was down 0.5% per year. In contrast, during the great depression of the 1930s it was down only 0.33% per year. It declined 90% by 1932, and then the market collapsed again in the late-1930s. By late-1936, John Maynard Keynes had a total British nest egg of 506,222 British pounds invested; 2 years later that money was worth only 181,244 British pounds (Sidelsky 2000). Here at home in 2007–2008, almost all asset classes declined by at least 50%. The only sector that did not erode was Treasury bills, notes and bonds. The reason? Investors regard Treasury securities as a safe haven (Kansas 2009).

Market risk is the danger that the investment sectors, including stocks, bonds, and mortgage-linked bonds will fall precipitously. Simply the possibility of this occurring erodes net worth, resulting in less capital and therefore less flexibility in investment. No one, other than the strange breed of short sellers, likes market crashes. As one might assume, different assets have different risk levels. Following is a list of assets that William Bernstein ranked from least to highest risk: (1) Treasury bills; (2) 5-Year Treasury notes; (3) 20-Year Treasury Bonds; (4) Large capital stocks; and (5) small-capital stocks (Bernstein 2001).

Another way to judge market risk is the standard deviation, or volatility, of various asset classes. The standard deviation during the twentieth century of the Standard and Poor's 500 is 14.5; small caps are at 20.68; large caps deviate at 16.94; emerging markets are 24.29; and 5-Year Treasuries are lowest, at 4.16 (Bernstein 2010). TIAA-CREF matches the market closely. In the last 10 years, this has not been a happy trend, but perhaps it is all that we can expect in this market.

Jeremy Siegel, professor at the Wharton School at the University of Pennsylvania, warns against what he calls the “growth trap” (Siegel 2005). Growth sectors shift fairly frequently, and when this happens, growth stocks are less likely to pay dividends or to raise them. For an income investor, growth engenders dangers without much positive potential. Growth is especially perilous if a competitor develops a better, cheaper product. Take a look at research in motion (RIM). This company successfully developed hand-held electronic devices. Yet it has been eclipsed not by new electronics firms, but by those that market cell-phones.

Another, quite modern problem confounds us. Wall Street successfully uses mathematical models and has done so for decades. Unfortunately, the 2008 collapse resulted as much from the misuse of these models as from the toxic assets that investment banks generated. No one can predict the future, but there is hope that modelers and users of these models will be more cautious in the future (Freedman 2011, pp. 77–79). Related to the mathematical risk is the nagging worry of unscrupulous brokers and their jaded advice. Brokers are not required to have your interests paramount in the advice they give you (Ajami 2010; Derman 2011).

What can one do about market risk? First one can refuse to play Wall Street games; money market funds are good, solid choices for the more cautious among us. However, today's low yields offer money market investors little income. But one

has a second alternative: one can buy dividend-paying and dividend-growth stocks (see Chap. 4). It has been proven historically that dividend-paying and dividend-growth stocks do not decline as much as those stocks devoid of dividends. Another possible choice is bond funds. These are reasonable because their yields rise when their market prices decline, and usually they experience no diminution of income during price reductions (see Chaps. 5 and 7).

2.3 Inflation

Inflation has been a menace both in historical and in contemporary times. Inflation destroyed the German middle class in 1923–1924, and has had devastating effects on Latin America. With fiscal affairs in disarray and large public debts hounding most countries, inflation becomes highly probable. Let us hope we can elude hyperinflation; that erodes all capital and savings and it often wipes out the middle class. But what do we do if inflation persists at 4% or 5%? One obvious remedy to this problem is to find dividend growth that exceeds 5% (see Chap. 4). Investors could also search for bond funds paying more than 5% and providing special dividends each year (see Chap. 5). This is possible, especially absent recessionary conditions. Most central banks are adept at steering their economies away from severe recessions while experiencing moderate inflation. So we will show how to minimize the risk of inflation for income, even retirement income.

Here we apply one of the mathematical formulae investors often use. This handy device, called the Rule of 72, yields the time it takes for a growth rate to double the quantity it represents. Here we apply it to the inflation rate. Since we all have calculators available, we will use the more precise form, which we call the rule of 69.3.¹ One simply divides 69.3 by a rate of increase. This rule tells us that 4% inflation means that prices double in a bit over 17 years. Five percent inflation causes a doubling of prices in 13 years, and 7% inflation doubles prices in less than 10 years. At this point we can share an open secret. You may be aware that our federal government publishes all manner of facts and directives based on the consumer price index (CPI). But did you know that in calculating the CPI the government deliberately and routinely underestimates inflation. This helps the government, but where does it leave us? Most consumers suffer from a higher rate of price hikes. Think about recent food price rises and the volatility of gasoline prices.

Inflation is a constant, nagging risk. Recent tumultuous markets mean inflation is possible, but not for the reason you think. Inflation is especially likely because of seigniorage, which literally means “lord of the realm.” In practice it implies that a government carrying a lot of debt will allow a certain amount of inflation in order to pay off its obligations more easily. Inflation helps long-term borrowers, such as mortgage holders, but it is dreadful for retirees living on fixed income.

¹This is because it is based on the natural log of 2, $\ln 2 = 0.6931$. To find out how long it takes for something to triple, use 110, which is based on $\ln 3 = 1.0986$.

2.4 Corruption

We often blame governments for corrupt practices, and local governments receive a good share of the blame. They are easy scapegoats. But corruption also exists in companies. Usually it is kept quiet except when rogue traders working for banks or brokerages lose huge sums of money. Unpublicized corruption in the private sector should concern investors most. A corrupt vice-president can cause almost any firm to collapse. Unfortunately, most investors do not find out about this until it is too late (Cruver 2002).

What can one do about unseen dangers such as this? Invest in the stock of large, multinational firms with good leadership and management control. The smaller a company is, the more easily it can be brought down. Think about this if you consider investing in small capitalization firms.

2.5 High Fees

High fees are part of Wall Street. Brokers, certified financial planners, certified financial advisers, mutual funds, and even exchange-traded funds get away with setting egregious fees (Stewart 1992). Not all Wall Street firms do, but most charge high fees (Augar 2005; Lefevre 1984). In addition, investors should beware of and try to avoid loads (or initial-investment fees). A load of 5% means only 95% of one's capital is actually invested in the market. The remainder of the investor's capital transfers to whomever is "helping" you. If the load is 5%, then chances are good that one pays even more in a monthly or annual charge. But even a 2% fee represents substantial deviation of capital and income. That amount is always deducted not only from investment capital, but also from the income one receives!

The reasonable fees TIAA-CREF charges are still higher than Vanguard's. Be proactive about this. Approach one's governing board or board of regents and ask if the university can acquire institutional fees at TIAA-CREF. Although TIAA-CREF fees are not high by commercial standards, institutional fees are substantially lower. And the lower the fee, the more capital that works for the investor; and more capital, of course, translates to potentially more income. Normally TIAA-CREF will not agree to institutional fees in its mandatory plan; however, it will allow them in voluntary plans, i.e., 403(b)s.

How does one avoid high fees? Do not deal directly with Wall Street. Use an electronic, discount brokerage. If you invest in mutual funds, buy no-load funds only. Many electronic brokerages offer incentives in which new customers enjoy free trading for a period of time. Some banks, such as Wells Fargo, allow customers with at least \$25,000 in deposits a generous number of free trades. Take advantage of these free trading opportunities. Just make sure you do not trade so frequently that you lose the long-term advantage of investing. Instead of churning your investments, you should choose good companies and build up your position over time.

2.6 The Next New Thing

We revel in new technology, and these days we find much to celebrate. But young technology firms usually need high infusions of capital. Therefore, they typically do not pay dividends until the business matures, e.g., Intel and Microsoft. Income investors should eschew embryonic firms or the indexes that include them, and instead, look for established, profit-making companies. And don't forget, bonds are an important component of any income portfolio.

2.7 Currency Risk

Currency risk used to be of concern only to the few investors who purchased foreign stocks or bonds. Consider the following example: An investor loaded up on Japanese stock in the late-1980s. Then a severe economic crisis descended causing the yen to decline by 40%. This unfortunate drop translated to a zero net gain for our beleaguered investor. The stocks purchased gained 40% in the first few years, but that matched the yen's decline. The difficulty is that as the economy has globalized, the currency problem has become universal. Now, when the US dollar rises, US stocks decline. Why? What is happening here? It's actually quite straightforward. If the US dollar climbs, so does the cost of US goods. This hurts US exports and ultimately companies' profits. Europe's debt problems, especially in the seventeen-country Euro zone, depressed equity prices for most of 2010 and 2011. So, why do their problems affect the USA? The European area has a large population of relatively affluent consumers who purchase great quantities of goods from the USA and Japan. When those customers feel financially pinched, they reduce purchases causing firms to falter.

The situation has now become a race to the bottom. Almost all finance ministers want their currencies to be low in order to foster exports. Switzerland, whose franc rose a great deal, became so frustrated by drooping sales that they linked the franc to the EU's Euro. This caused the franc to decline in value, thus enabling more exports at lower prices. In today's global market, no one wants an expensive currency. What can an investor do about this? Buy stock in large, multinational companies that have dealt with currency problems since 1971, when the USA left the gold standard and currencies "floated." The chief financial officers of these firms have experience handling currency fluctuations. You might look at Johnson & Johnson (JNJ), McDonald's (MCD), Procter & Gamble (PG), Walgreens (WAG), Wal-Mart (WMT), and Siemens (SI). Alternatively, US investors could turn to firms such as domestic utilities, because they are not affected as much by currency risks (see Chap. 4).

2.8 Lethargy

Could inertia and lethargy possibly present serious financial risks? Absolutely, because the earlier one begins to invest, and the more compounding works favorably. Generating \$1,000 in retirement income requires investing \$4,500 at age 45, \$7,700 at age 50, and \$37,200 at age 60. Fifty-six percent of those born between 1965 and 1976 have increased their spending while ceasing to save. The same is true of 48% of those adults born after 1976 (*Enlightened Investor*, Fall 2011). By virtue of lower capital infusions one would be much better off if investing began right away. In fact, the sooner, the better!



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