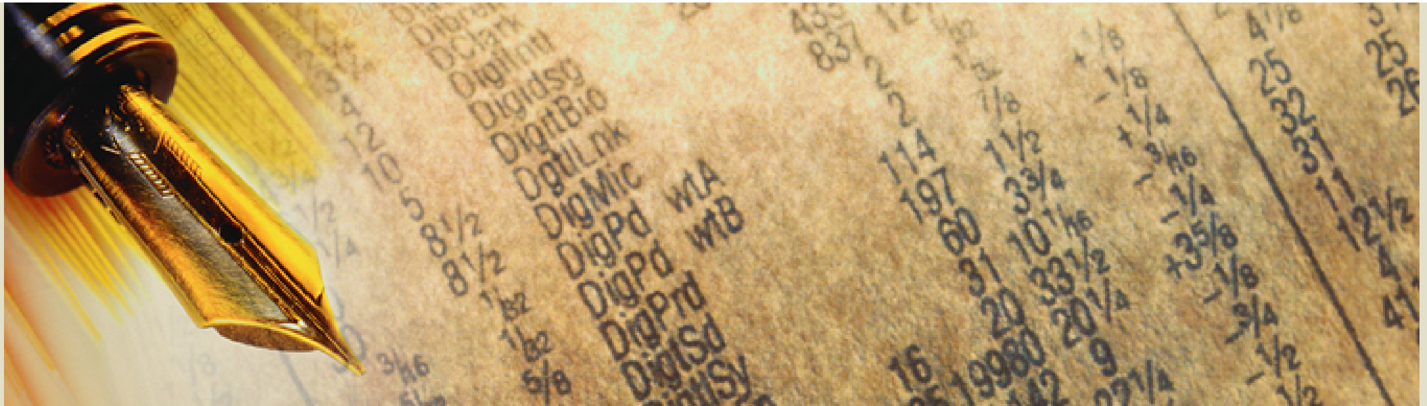
The High Price of Low Risk



When markets turn volatile, when returns approach zero or occasionally dip into the red, it's not uncommon for investors to worry about their carefully constructed portfolios and consider realigning them with the most stable investments – those that seem to carry the least risk. It's an understandable temptation, but one to be resisted.

Risk is like the air in your tire. Reduce it to almost nothing and the tire may still roll, but you're not likely to reach your destination in time, and you face the possibility that your tire will start shredding before you get very far. The good news is, whatever happens, you won't need to worry about excessive speed.

In financial terms, putting your faith entirely in the lowest-risk investments can undermine your portfolio, whether your goals stretch toward retirement or are set on nearer-term objectives. The good news is you probably won't actually lose money.

Cost of Security

Low-risk alternatives abound: savings accounts, certificates of deposit, money market funds. True, they are safer places to store your cash than stuffing it under your mattress, but you can forego potentially substantial financial gains.

Consider these figures from an Ibbotson Associates study of average annual returns during the 20-year period from 1986 through 2005: money market funds, 4.74%; U.S. stocks, 11.93%; international stocks, 10%; real estate, 9.88%; international bonds, 8.74%; and U.S. bonds, 7.93%. Although such figures illustrate past performance that does not indicate future performance, the message is clear: over time, real gains come from the riskier investments.

During this 20-year period, the average annual inflation rate was 3.03%,* so the average money market investor would have kept slightly ahead of inflation. Those investing for real financial growth, however, were lost unless they had stayed invested in somewhat riskier stocks and bonds. That would have meant riding through the market crash in October 1987, the Asian financial crisis of 1997, the dot-com bubble burst in March 2000, and the recessions of 1990 to 1991 and 2001 to 2003. But portfolios of U.S. or international stocks would have gained more than 10% annually, and even bond investors would have gained nearly 8% annually – far outpacing inflation.

Inflation's Toll

In a sense, financial success depends on subduing inflation. If just keeping up is your objective, low-risk investments might do the trick. But if you have loftier goals, a totally low-risk portfolio is unlikely to produce what you want.

Studies have shown that well-diversified portfolios – carefully chosen mixes of risky and less-risky investments – can help reduce volatility while delivering decent performance over the long term. Ibbotson's 20-year study showed a well-diversified portfolio returning an average annual return of 9.46%. That's the kind of return that can help propel your portfolio toward its goal.

If you have questions about your portfolio's make-up, please don't hesitate to call me.

Material prepared by Raymond James for use by its financial advisors.

Past performance is not indicative of future results. Diversification does not ensure a profit or protect against a loss.