[You must stay invested in the securities markets to earn market risk premiums]

Category : Asset Allocation and Personal Investment Risk Tolerance Articles

Published by The Skilled Investor on Feb/23/2007

You must stay invested in the securities markets to earn market risk premiumsThe securities markets pay risk premiums. You have to have your money invested and at risk to be paid a risk premium. Attempting to avoid risk or losses by jumping in and out to "time the markets" does not work. Scientific finance studies demonstrate the both amateurs and professionals are lousy at market timing.Historically, U.S. securities markets have paid substantial risk-adjusted returns or risk premiums to investors. While risk premiums have been substantial, they have occurred irregularly. There have been intervening periods of losses, some of which were substantial. (See: How stable have common stock equity risk premiums been over time?)To earn market risk premiums, your assets must be invested and exposed to potential risk or loss. The more risk you can tolerate, then the higher your potential return and perhaps the rougher the investment road you may travel. Those who have better emotional tolerance for asset volatility can more easily weather market sell-offs. Practical considerations will also affect your tolerance of investment risk. In difficult times, whether you need to liquidate risky assets at depressed prices will depend on your expenses and on your other other holdings of less risky, salable assets. Paying necessary living expenses and taxes are good reasons to withdraw funds. Trying to time the markets for a better return is not a good reason. If you do not need to take out money during a market retreat and recovery cycle, then risk tolerance is solely emotional. For a risk tolerant investor with stable earned income, the recent bubble crash was just a few years of unpleasantness, if he or she was fully diversified and, therefore, not heavily loaded with technology and communications equities. The same, however, could not be said for those who were poorly diversified and also found themselves to be highly risk averse, when risk actually happened. This is especially true, if job loss forced the liquidation of assets at depressed values.To some degree, all sane individual investors are averse to risk, so risk tolerance is a relative rather than absolute issue. Therefore, you need to judge your preference or tolerance for risk relative to other investors. While very few people like investment risk, those who can tolerate it better are those who will be less uncomfortable when risk happens from time to time and market values decline by a little or a lot. Tolerating the potential for loss is the cost that investors occasionally pay so that they are always at the table, when the markets deliver their positive rewards.The vast bulk of individual investors’ publicly traded investment assets are held in the primary cash, fixed income, and equity financial asset classesin the form of individual securities or funds. Your relative investment risk tolerance should influence how your assets are allocated among these primary financial asset classes. If your actual asset allocation is more risky than your risk tolerance, you may not be able to handle the downturns. You might panic, when you should stand firm. If your asset allocation is less risky than your risk tolerance, then you are likely to need to spend less and save at a higher rate to reach your goals.Nothing is certain about this process, and that is the nature of investment risk. However, the scientific investment literature is relatively clear on certain points. Amateur and professional investors are just not good at timing changes in the markets. Active strategies that attempt to time market turns have under-performed continuous investment strategies. Consistently and profitably calling serial market turns correctly has been a skill beyond mere mortals and certainly beyond the skill of even the most proud of professional and individual investors.It is better to buy into the asset markets in proportion to your preferred asset allocation and risk tolerance and to stay in the securities markets through thick and thin. Trying to sit on the sidelines and jump in when things seem safe simply does not work. When things seem safer, they also seem safer to others. In this situation, securities prices will have already reflected this confidence. Most of the "upside juice" or risk premium will already be reflected in current asset prices and only current securities holders will have been paid. (See: Introduction to investment valuation and securities risk) The converse of trying to jump out to avoid the downturns also does not work. Real-time securities markets are auctions about the expected value of future securities returns. Particularly toward the downside, markets can react extremely rapidly. Getting out in time does not work, because it is usually too late when you realize you should have sold. Worse, however, you might jump out too early and be absent from the table when the market moves upward. Staying in the markets just tends to work better. If you are more highly risk averse, it is more appropriate for you to select an asset allocation that reflects your relatively higher risk aversion. You would hold a relatively small portion of your assets in the more risky equity asset class. Therefore, you might be more comfortable and more able and likely to keep your smaller equity allocation invested at all times. Having a smaller, but sustained exposure to equity assets tends to work much better for the more risk averse investor, compared to jumping in and out of the equity markets in larger proportions.If you stay out of the markets due to such fears, then you are likely to need to save far more to reach your goals. Over-cautiousness is not a free ride. There is never a safe time to be in the markets, because investing is always inherently risky. There is never a safe time to be out of the markets, because you cannot earn investment risk premiums on the cash under your mattress. (See: VeriPlan helps your to compare investment risk-return tradeoffs)Finally, you should periodically rebalance you assets back toward your planned asset allocation proportions. To minimize the negative impacts of investment transactions costs and taxes, you should rebalance infrequently and in a planned manner that anticipates deposit and withdrawal transactions that you would need to do anyway for other reasons.

If you want to understand your personal asset allocation and risk-return tradeoffs over your lifetime, VeriPlan provides powerful, automated "what-if" planning facilities. You can rapidly develop and analyze a range of fully personalized scenarios to see whether your asset allocation strategy would achieve your objectives with a level of risk that is acceptable to you. VeriPlan provides five adjustable and fully automated mechanisms to determine your preferred lifecycle asset allocation. VeriPlan gives you full control over rates of asset returns and asset return variability, and it automatically rebalances your assets annually. It even projects the annual expense coverage by your safer cash and bond assets throughout your lifecycle.

SCROLL ALL THE WAY DOWN FOR LINKS TO OTHER ARTICLES IN THIS CATEGORY