

## Four Risks, Four Bricks

In our January newsletter last year, as others deluged you with economic and investment predictions for 2011, we warned against the perils of believing that you, or anyone else, could predict future events accurately. This year, we repeat this theme ~ if you need further convincing of the concept, consider the roller-coaster course of the financial markets in 2011.

On July 25, 2011, the price of the S&P 500 index of large U.S. stocks was up over six percent for the year. *Ten trading days later*, on August 8, it was down 11 percent for the year. The specific cause of this waterfall decline was a credit downgrade of U.S. Treasury debt. The financial market reaction to the downgrade was panic selling of virtually all assets *except* for U.S. Treasury debt, the very instrument downgraded, which saw panic *buying* in a “flight to safety.” Long-term Treasury bonds were the best performing major asset in 2011. The more general cause of the unstable markets in 2011 was the financial crisis in Europe. Knowing that now, if you used your time machine to go back a year to invest in your choice of Japan, Asia ex-Japan, Europe, Latin America or emerging markets generally, you probably would be disappointed. The best relative performance by equities from these regions over the past year was ... Europe.

Therefore, we will not waste time on predictions – and by the time you read this, you may be losing steam on your New Year’s resolutions. The beginning of a new year, however, is also a good time to go back to basics. In investing, after a chaotic year like 2011, this is especially true. The basic, fundamental relationship in investing is the tradeoff between risk and return, but how should you define risk? We believe there are four categories: (1) capital loss risk; (2) purchasing power risk; (3) longevity risk; and (4) behavioral risk. Everyone understands the first – it is painful when the value of your portfolio declines. There is no chance you will ignore this risk, since news headlines trumpet any market decline. Almost all investors can tell you what the markets have been doing lately. The other three risks, though, are more subtle and therefore more easily missed.

Purchasing power risk is inflation eating away at the value of your portfolio. When you sent letters home from summer camp as a kid, what was the denomination of the stamp? Prices tend to rise, and money to lose relative value, over time. If capital loss risk is like a house fire, attracting immediate attention, purchasing power risk is like dry rot – you do not tend to notice it until it is too late. Longevity risk exists because you do not know how long you will live, despite predictions in an actuarial table. All investments are a hedge against future purchases, and your retirement portfolio is a hedge against purchases you will make if you live to age 100. Behavioral risk occurs when fear or greed impels you to deviate from your rational, long-term plan and do something stupid – loading up on technology stocks in late 1999, buying a spec house in 2007 or selling everything to move to cash in early 2009. You may have the best-designed investment plan ever conceived, but it will not work if you cannot follow it.

*“And simple truth  
miscall’d simplicity.”*

-- Shakespeare, *Sonnet 66*

Understanding these risks and bravely confronting them, how do you proceed? Many investors make things too complicated. When you construct a portfolio, it is like building a wall with four different bricks – stocks, bonds, cash and real assets. Turn on CNBC and you likely will hear someone telling you how much they dislike one of these bricks – and they might be right. That does not end the problem, though – you cannot opt out of building your portfolio wall. Not using one of the bricks simply means you will be using more of the other three. Don’t like stocks or real assets? Fine – but then all your money winds up in low-yielding bonds and cash. You might sleep better tonight thinking you have avoided the risk of capital loss, but in the future, you face substantial purchasing power risk if inflation heats up. You also increased longevity risk, since now you probably do not have enough gas in the tank to get you where you would need to go over a long retirement. The behavioral risk also will kick in when your friends start making seemingly easy money in some bull market of the future. “Solving” one risk tends to increase the others; you need to achieve an appropriate balance between your risks and bricks.

In response to the distaste investors might have now for each of our four bricks, Wall Street claims to invent new bricks for your wall, products such as hedge funds or alternative assets. They count on investors to make a category mistake and consider these new products to be different asset classes – but they are the same old bricks, packaged differently. It is important to call things by their real names, to see things as they are. An “alternative asset” is just some combination of our four bricks inside a pretty box with a new label.

Enclosed is our annual listing of different asset returns (three sub-categories of stocks and one category of bonds), with a box around the best-returning asset each year. In 2011, bonds took the honors. Whenever you are inclined to see a pattern, it disappears. On the right are portfolio mixes –the diversified aggressive and balanced mixes have tended to do about as well or better than individual assets over time with less volatility. Investing is not about predicting the future but having a rational plan you can follow. Our only prediction for the markets this year, as it was last year, is “uncertainty” – we were right on that in 2011 and we like our chances for a repeat this year.