Bellmore Group Management Services, Tokyo Japan's 3 Risks of Investing in the Stock Market

Risk and reward are inextricably intertwined, and therefore, risk is inherent in all financial instruments. As a consequence, wise investors seek to minimize risk as much as possible without diluting the potential rewards. Warren Buffett, a recognized stock market investor, reportedly explained his investment philosophy to a group of Wharton Business School students in 2003: "I like to go for cinches. I like to shoot fish in a barrel. But I like to do it after the water has run out."

Reducing all of the variables affecting a stock investment is difficult, especially the following hidden risks.

1. Volatility

Sometimes called "market risk" or "involuntary risk," volatility refers to fluctuations in price of a security or portfolio over a year period. All securities are subject to market risks that include events beyond an investor's control. These events affect the overall market, not just a single company or industry.

They include the following:

- **Geopolitical Events**. World economies are connected in a global world, so a recession in China can have dire effects on the economy of the United States. The withdrawal of Great Britain from the European Union or a repudiation of NAFTA by a new U.S. Administration could ignite a trade war among countries with devastating effects on individual economies around the globe.
- **Economic Events**. Monetary policies, unforeseen regulations or deregulation, tax revisions, changes in interest rates, or weather affect the gross domestic product (GDP) of countries, as well as the relations between countries. Businesses and industries are also affected.
- **Inflation**. Also called "purchasing power risk," the future value of assets or income may be reduced due to rising costs of goods and services or deliberate government action. Effectively, each unit of currency – $1 in the U.S. – buys less as time passes.

Volatility does not indicate the direction of a price move (up or down), just the range of price fluctuations over the period. It is expressed as "beta" and is intended to reflect the correlation between a security's price and the market as a whole, usually the S&P 500:

- A beta of 1 (low volatility) suggests a stock's price will move in concert with the market. For example, if the S&P 500 moves 10%, the stock will move 10%.
- Betas less than 1 (very low volatility) means that the security price fluctuates less than the market – a beta of 0.5 suggests that a 10% move in the market will produce only a 5% move in the security price.
- A beta greater than 1 (high volatility) means the stock is more volatile than the market as a whole. Theoretically, a security with a beta of 1.3 would be 30% more volatile than the market.

According to Ted Noon, senior vice president of Acadian Asset Management, implementing low-volatility strategies – for example, choosing investments with low beta – can retain full exposure to equity markets while avoiding painful downside outcomes. However, Joseph Flaherty, chief investment-risk officer of MFS Investment Management, cautions that reducing risk is "less about concentrating on low volatility and more about avoiding high volatility."

Strategies to Manage Volatility

Strategies to reduce the impact of volatility include:

- **Investing in Stocks With Consistently Rising Dividends**. Legg Mason recently introduced its Low Volatility High Dividend ETF (LVHD) based on an investment strategy of sustainable high dividends and low volatility.
- **Adding Bonds to the Portfolio**. John Rafal, founder of Essex Financial Services, claims a 60%-40% stock-bond mix will produce average annual gains equal to 75% of a stock portfolio with half the volatility.
- **Reducing Exposure to High Volatility Securities**. Reducing or eliminating high-volatility securities in a portfolio will lower overall market risk. There are mutual funds such as Vanguard Global Minimum Volatility (VMVFX) or exchanged traded funds (ETFs) like PowerShares S&P 500 ex-Rate Low Volatility Portfolio (XRLV) managed especially to reduce volatility.
- **Hedging**. Market risk or volatility can be reduced by taking a counter or offsetting position in a related security. For example, an investor with a portfolio of low and moderate volatility stocks might buy an inverse ETF to protect against a market decline. An inverse ETF – sometimes called a "short ETF" or "bear ETF" – is designed to perform the opposite of the index it tracks. In other words, if the S&P 500 index increases 5%, the inverse S&P 500 ETF will simultaneously lose 5% of its value. When combining the portfolio with the inverse ETF, any losses on the portfolio would be offset by gains in the ETF. While theoretically possible, investors should be aware that an exact offset of volatility risk in practice can be difficult to establish.

2. Timing

Market pundits claim that the key to stock market riches is obvious: buy low and sell high. Good advice, perhaps, but tough to implement since prices are constantly changing. Anyone who has been investing for a time has experienced the frustration of buying at the highest price of the day, week, or year – or, conversely, selling a stock at its lowest value.

Trying to predict future prices ("timing the market") is difficult, if not impossible, especially in the short-term. In other words, it is unlikely that any investor can outperform the market over any significant period. Katherine Roy, chief retirement strategist at J.P. Morgan Asset Management, points out, "You have to guess right twice. You have to guess in advance when the peak will be – or was. And then you have to know when the market is about to turn back up, before the market does that."

This difficulty led to the development of the efficient market hypothesis (EMH) and its related random walk theory of stock prices. Developed by Dr. Eugene Fama of the University of Chicago, the hypothesis presumes that financial markets are information efficient so that stock prices reflect all that is known or expected to become known for a particular security. When new data appears, the market price instantly adjusts to the new conditions. As a consequence, there are no "undervalued" or "overvalued" stocks.

Coping with Timing Risk

Investors can mollify timing risks in single securities with the following strategies:

- **Dollar-Cost Averaging**. Timing risks can be reduced by buying or selling a fixed dollar amount or percentage of a security or portfolio holding on a regular schedule, regardless of stock price. Sometimes called a "constant dollar plan," dollar-cost averaging results in more shares being purchased when the stock price is low, and fewer when the price is high. As a consequence of the technique, an investor reduces the risk of buying at the top or selling at the bottom. This technique is often used to fund IRA investments when contributions are deducted each payroll period. NASDAQ notes that practicing dollar-cost averaging can protect an investor against market fluctuations and downside risk.

- **Index Fund Investing**. In the classic example of "If you can't beat them, join them," Fama and his disciple, John Bogle, avoid the specific timing risks of owning individual stocks, preferring to own index funds that reflect the market as a whole. According to The Motley Fool, trying to accurately call the market is beyond the capability of most investors, including the more prominent investment managers. The Motley Fool points out that less than 20% of actively managed diversified large-cap mutual funds have outperformed the S&P over the last 10 years.

3. Overconfidence

Many successful people reject the possibility of luck or randomness having any effect on the outcome of an event, whether a career, an athletic contest, or investment. E.B. White, author of Charlotte's Web and a longtime columnist for The New Yorker, once wrote, "Luck is not something you can mention in the presence of a self-made man." According to Pew Research, Americans especially reject the idea that forces outside of one's control (luck) determine one's success. However, this hubris about being self-made can lead to overconfidence in one's decisions, carelessness, and assumption of unnecessary risks.

In October 2013, Tweeter Home Entertainment Group, a consumer electronics company that went bankrupt in 2007, had a stock price increase of more than 1,000%. Share volume was so heavy that FINRA halted trading in the stock. According to CNBC, the reason behind the increase was confusion about Tweeter's stock symbol (TWTRQ) and the stock symbol for the initial offering of Twitter (TWTR).

J.J. Kinahan, chief strategist at TD Ameritrade, stated in Forbes, "It's a perfect example of people not doing any homework whatsoever. Investing can be challenging, so don't put yourself behind the eight-ball to start." Even a cursory investigation would have informed potential investors that Twitter was not publicly traded, having its IPO a month later.

Stock market success is the result of analysis and logic, not emotions. Overconfidence can lead to any of the following:

- **Failure to Recognize Your Biases**. Everybody has them, according to CFP Hugh Anderson. Being biased can lead you to follow the herd and give preference to information that confirms your existing viewpoint.
- **Too Much Concentration in a Single Stock or Industry**. Being sure you are right can lead to putting all your eggs in a single basket without recognizing the possibility that volatility is always present, especially in the short term.
- **Excessive Leverage**. The combination of greed and certainty that your investing decision is right leads to borrowing or trading on margin to maximize your profits. While leverage increases upside potential, it also increases the impact of adverse price movement.
- **Being on the Sidelines**. Those who feel the most comfortable in their financial capabilities often believe that they can time the market, picking the optimum times to buy, sell, or be out of the market. However, this can mean you will be out of the market when a major market move occurs. According to the DALBAR 2016 Quantitative Analysis of Investor Behavior, the average investor – moving in and out of the market – has earned almost half of what they would have made for the last 15 years if they had matched the performance of the S&P 500. J.P. Morgan's Roy notes that if an investor had been out of the market just the 10 best days over the past 20 tears – a span of 7,300 days – the return would be slashed in half.

Strategies to Stay Grounded

Strategies to reduce the impact of overconfidence include:

- **Spread Your Risk**. While not a guarantee against loss, diversification protects against losing everything at once. Jim Cramer of TV's Mad Money recommends a minimum of 10 stocks and a maximum of 15 in a portfolio. Less than 10 is too much concentration, and more than 15 is too difficult for the average investor to follow. Cramer also recommends investing in five different industries or sectors. Investors should note that one benefit of mutual funds and ETFs is automatic diversification.

- **Buy and Hold**. Warren Buffett is perhaps the most famous and ardent proponent of the buy and hold strategy today. In a 2016 interview with CNBC's On the Money, Buffett advised, "The money is made in investments by investing, and by owning good companies for long periods of time. If they [investors] buy good companies, buy them over time, they're going to do fine 10, 20, 30 years from now."

- **Avoid Borrowing**. Leverage is when you borrow money to invest. And while leverage can magnify profits, it can also amplifies losses. It increases the psychological pressure to sell stock positions during

market downturns. If you tend to borrow to invest (to pay for your lifestyle), you would do well to remember the advice of popular financial gurus such as Dave Ramsey, who warns, “Debt is dumb. Cash is king.” Or Warren Buffett, who claims, “I’ve seen more people fail because of liquor and leverage – leverage being borrowed money. You really don’t need leverage in this world much. If you’re smart, you’re going to make a lot of money without borrowing.”

Final Word

“It’s not what you make, it’s what you keep that matters.” The source of this widely recognized quote is uncertain, but it can be found in almost every list of famous quotes about the stock market. The saying illustrates the need to reduce risk as much as possible when investing. Achieving significant stock market gains, only to lose them when a disastrous event occurs, is devastating – and often unnecessary.

Robert Arnott, founder of the Research Affiliates asset management firm, identified the dilemma in the relationship between risk and return: “In investing, what is comfortable is rarely profitable.” By employing some of these strategies, such as dollar-cost averaging, reducing portfolio volatility, and diversification, you can protect your wealth and sleep better at night.

Are you concerned about the risks in the stock market? What steps do you take to reduce your exposure to negative events?