JANUS LABS DECISION POINT SERIES

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Rethinking Risk: It's About Time

For all the academic theorizing devoted to understanding and managing risk, it remains an elusive concept for most investors, and a personal one. Yet rethinking how risk is defined and assessed can improve your portfolio performance over time.

WHAT DOES RISK MEAN TO YOU?

Risk is about more than figuring out the likelihood of losing money on a specific investment, it's about assessing the likelihood of failing to meet a particular goal by being improperly invested.

People invest with the expectation that the money they have saved will increase in value, and they plan for the future with those expected increases in mind. But the only way to reach financial goals is to take on some degree of risk. The question of how much risk to assume is one of the most important decisions you can make as an investor.

RISK IS MORE THAN VOLATILITY

Traditionally, volatility and risk have been considered synonymous. Though this makes intuitive sense, it leads to confusion and bad decisions for many investors.

The more a stock deviates from the market or a risk-free asset like Treasury bills (T-Bills), the more volatile it is. The market performance of small-cap stocks, for example, tends to be far more volatile than for large-cap stocks. For this reason they are considered riskier investments. Are they really? Investors tend to confuse such short-term volatility with long-term risk—and this can lead to crucial mistakes in the allocations they make in their portfolios.

Two views of risk

Many advisors and institutional investors employ Modern Portfolio Theory (MPT) to help manage risk. It does this by incorporating a variety of mathematical models to create a portfolio with an optimal mix of assets. The objective is to produce the highest possible returns with the least amount of volatility. While this addresses volatility, it does not necessarily address the bigger risk—that financial objectives may not be met.

TRADITIONAL VIEW OF RISK = VOLATILITY

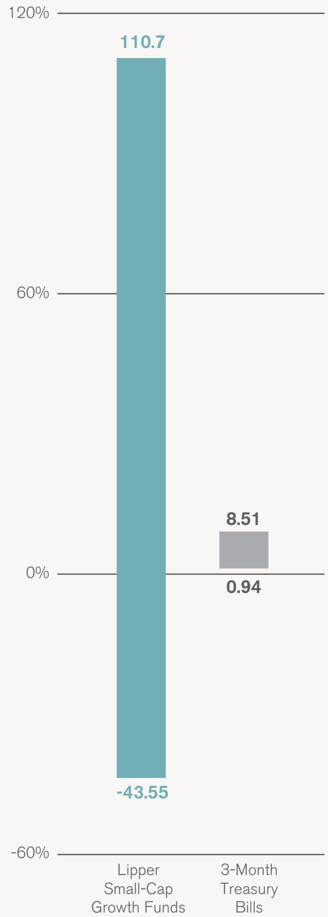
ALTERNATIVE VIEW OF RISK = FAILURE TO ACHIEVE GOALS

= investment goal

How time determines what is "risky"

SHORT-TERM VIEW: SMALL-CAPS MORE VOLATILE THAN T-BILLS

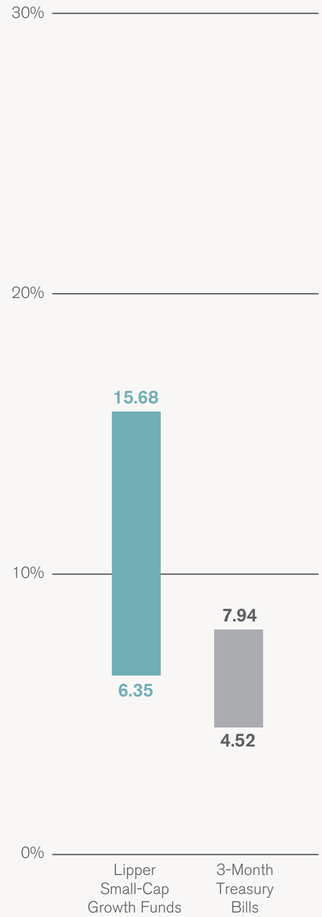
1-Year Average Return Range



Source: Lipper
Time periods beginning 1987-2007.

LONG-TERM VIEW: VOLATILITY PICTURE IS MUCH DIFFERENT

Rolling 20-Year Average Return Range



Source: Lipper
Time periods beginning 1960-2007.

As the investment horizon lengthens, "riskier" asset classes, while still exhibiting high periodic volatility, are much more likely to generate the returns necessary to achieve long-term goals.

The volatility of a small-cap growth stock fund would be much greater in a 12-month time frame than a T-bill, but that fund would also be much more likely to meet an investor's needs over 20 years. In fact, over time, small caps have significantly outperformed T-bills. Even the worst period for small cap performance produced higher returns than the best period for T-bills. So which investment is riskier? The answer depends on how much time the investor has to meet their goals.

CONFUSING CERTAINTY WITH SAFETY

How much risk an investor can tolerate is something only time can tell. In other words, if you'll need your money five years from now, your risk tolerance may be far lower than if you don't need it back for 20 years.

MPT defines risk as standard deviation or the annualized variance of monthly returns (also referred to as volatility). But basing investment decisions on this conventional notion of risk may lead to very different investment results than if decisions are based on 20-year time horizons. After all, what's considered risky in a 12-month time frame may be entirely different from what is risky over 20 years.

For example, investing in T-bills is considered to be a very conservative, risk-averse strategy. Certainly this is true if risk is measured by standard deviation. And it may very well be the most appropriate strategy if an investor is saving for near-term goals. But standard deviation is by definition a short-term calculation. If the investor's financial goal is 20 years off, investing in T-bills may paradoxically be the riskiest strategy. The investment may be safe, but T-bills are unlikely to produce enough of a return to help the investor achieve their goal. Confusing certainty with safety is one of the biggest mistakes an investor can make.

RETHINKING RISK IN A PORTFOLIO

The conventional approach to risk management tries to characterize risk tolerance by labeling investors as "conservative," "aggressive" or somewhere in between. This is really too simple to be useful. It is not so much a matter of attitude, but how much time an investor has to reach a goal that should dictate the strategy.

If the goal is longer term, the investor might invest in a way that would conventionally be considered aggressive. Conversely, if the goal is shorter term, the investor might allocate investments in a more conservative manner. However, most investors have multiple goals of varying time frames—some requiring aggressive strategies, others calling for more conservative strategies.

Goals of similar duration and required return can be considered as part of an integrated portfolio with a common strategy. However, if a goal has unique requirements (e.g., requiring a short-term capital preservation strategy) it may need to be isolated and its strategy considered separately.

DECISION POINT: RISK ASSESSMENT

These questions are deceptively simple but the answers can help set the framework for a holistic strategy that takes into account different goals.

1. How much do I have to invest?
2. How much do I need to reach my financial goals?
3. How long do I have before I need it?

The time frame and level of growth required for each goal will dictate the strategy and whether it should be aggressive or conservative.

WHEN IT COMES TO RISK, IT'S PERSONAL

Rather than try to pretend it's not there or avoid it altogether, a rational investor needs to make the right kind of risk work for his or her portfolio.

Ultimately, defining risk is so difficult because it does not apply universally to everyone (contrary to MPT) and cannot be easily generalized. It is a very personal notion—influenced by your life's experiences, your psychological makeup and your goals and dreams. Yet no matter how risk is defined, there's no way to avoid it when making investment decisions. An investor could put all her money into CDs and think she's avoiding downside risk altogether, but then run the bigger risk of having so little appreciation that college tuition or retirement is not fully funded. Ignoring one form of risk can lead to excessive risk in another form.

To determine the appropriate risk management strategy for your portfolio, discuss your goals with your advisor and share the time frame and resources you have for meeting them.

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