



It Works Until it Doesn't

THE RISK OF TAKING RISK – A PRIMER

Gregg L. Haglund

First Vice President - Investment Officer
PIM® Portfolio Manager

Investment and Insurance Products are:

- Not Insured by the FDIC or Any Federal Government Agency
- Not a Deposit or Other Obligation of, or Guaranteed by, the Bank or Any Bank Affiliate
- Subject to Investment Risks, Including Possible Loss of the Principal Amount Invested



Risk. The risk I will address here is investment risk. Although, truth be told, the bigger risk is ourselves. First, you must appreciate the following:

We are animals, lest we forget.

For nearly our entire history as a species, we were hunter-gatherers, living in small tribes, seeking mates, finding shelter, foraging for food, pursuing prey and avoiding predators.

If we were to survive, we needed to pursue rewards and avoid risks as quickly as possible.

We have only been investing for a fraction of our existence, and have been running from lions the rest of the time.

Financial losses are processed in the same areas of the brain that respond to mortal danger.

The neural activity of someone whose investments are making money is indistinguishable from that of someone who is high on cocaine or morphine.

As neuroscientists will tell us, evolution has designed our emotions to make us do what our ancestors had to do. The Reflexive System is very sophisticated and served us well for millions of years. But in a modern world, where life is much more complicated than just immediate threats – it's not adequate and is likely to get us in trouble.

***“If you burn your mouth with hot milk,
next time you blow on your yogurt”***

— Turkish proverb

Let's fast forward. Risk redefined.

Risk though, is like matter, it can neither be created nor destroyed. It just exists. When you buy a safe investment, like a U.S. Treasury Bill, you are not eliminating your risk; you are just switching out of the risk of losing your money into the risk of losing purchasing power. The risk hasn't gone away; you have just substituted one risk for another.

In the financial markets, psychological comfort is over-rated. The path to superior investment performance is generally through psychological discomfort. There is a DALBAR study that states “The main reason for losing money is trying not to lose money” As a 30 year veteran in this industry, truer words have never been spoken.

Risk is fundamental to investing, but there are numerous definitions to be sure. Is volatility risk? Perhaps, based on our ancestral Ventromedial Prefrontal Cortex, but most volatility really stems from crowds overreacting to information. Indeed, minimal volatility can be explained by changes in the underlying economic fundamentals at the market level (corporate earnings, interest rates). Volatility measures emotions, not necessarily investment risk. But unfortunately, the investment industry has adopted this same volatility as a risk measure that, rather than focusing on the final outcome, focuses on the bumpiness of the ride.

I believe that risk and volatility are not interchangeable. Emotion is not risk. Focusing on short-term volatility when constructing a long-term portfolio will often lead to long-term under-performance.

Quite often I see this industry mistakenly build portfolios that minimize short-term volatility relative to long term results, placing emotion at the very heart of the long-horizon portfolio construction process. This approach unfortunately is popular because it legitimizes the emotional reaction of investors to short-term volatility. I submit that the real risk is the risk of underperformance. Most financial advice is about today – what should I do now, but the vast majority of the time, I've come to realize that today isn't that important.

Many investors pull out of the stock market when faced with heightened volatility. But research shows this is exactly when they should remain in the market and even increase their stock holdings, as subsequent returns are higher on average. It is also the case that many investors exit after market declines only to miss the following rebounds. Following the 2007 - 2008 market crash, investors withdrew billions of dollars from equity mutual funds during a period in which the stock market more than doubled. In 2007, to early 2008 the perceived risk was being over invested. Afterwards the risk was being under invested, missing the gains from the rally, also known as "opportunity cost". The end result of such reactionary behavior is that investors frequently suffer the pain of losses without capturing the subsequent gains. Again, truth be told the bigger risk is ourselves. (Did you sell your home when it declined 25%)

Please take a moment to look at the chart at the end of this article. This is one of the more telling visuals on this topic spanning 35 years. It shows the intra-year declines and how the market ended up afterwards. Over the last three decades we have averaged a correction (market sell-off) of about 14% each year. Now take a look at just where we ended up. Knowing and understanding this will help you tremendously.

Generally investors seek to minimize the emotional experience as much as they can. Let me offer you this. Don't get influenced by what you think might happen. Stay away from the noise. The markets don't care what you think. And they don't care what the talking heads think either. Minimize your failure rate and pay no attention to the financial news. Do you plant an acorn seed and go the backyard to watch it grow every day?

Can you imagine if the grand visions of Getty, Morgan, and Carnegie were reviewed and debated for 10 hours each day on T.V., with pundits second guessing the outcomes. Please let us not lose sight that great achievements take time, patience, setbacks, moments of loss (lives, time, money, support). Maybe your IRA will not advance mankind, but let it be the best it can be none-the-less.

“It is only the price on the final day that counts”

— Warren Buffet

From 1980 – 2013, Warren Buffet's stock, Berkshire Hathaway, has had compounded at 21% per year. But those returns didn't always come easy.

Berkshire Hathaway (BRK-A) Largest Losses*	
1981 – 1982	-19%
1987	-37%
1989 – 1990	-37%
1998 – 2000	-49%
2007 – 2009	-51%

*Largest losses since 1980

The one percent. The “one percent” phrase has been used quite a bit to decry income inequality, but I'm using here in a different context. Most of what matters as a long-term investor is how you behave during the one percent when the world appears to be collapsing around you. Maybe your behavior during the one percent of the time is how you get to be part of the one percent.

The cost of equating risk and emotional volatility can be seen in other areas as well. Let me parse this thought in non-financial terms. A flying analogy illustrates this separation process. All of us who fly have experienced turbulence, which can range from unnerving to downright frightening. When asked about their flights, many travelers will comment on the amount of turbulence they encountered. But we know from years of FAA research that turbulence rarely causes injury or death. Instead, pilot error and other human errors are the leading causes of plane crashes.

What if the FAA had listened to passengers to determine the risk of flying? Rather than meticulously studying each accident and uncovering the true cause, the FAA would have spent considerable time trying to reduce turbulence, as requested by passengers, thus missing the critical role of human error in accidents.

By focusing on short-term turbulence they would have actually made flying more dangerous. But they did not, and as a result we have just experienced the safest years in commercial flight since the dawn of the jet age. The path to the outcome is less important and has little influence on the measure of risk. Risk takes on many guises and can mean different things to different people. Each investor will have a different set of bad times defined by their liabilities, income stream, how they tolerate losses (or not) and other salient investor characteristics.

Be aware of the following:

Negative outcomes. Investors who are strongly risk adverse are more inclined to lose discipline and stray from a carefully constructed plan when the risk actually does show up.

This is a valid and highly practical point. Sound strategies will from time to time deviate from the norm. Allow the strategy to run its course. Changing horses in the middle of the stream rarely has a positive outcome.

Relating the stock market action to the economy.

The risk of confusing the economy and stock market action. This unfortunately is a very common and harmful risk. I will not address the reasons here, but there is a disconnect between the two as the chart will show. Great damage has been done by reacting to the current events with the belief that the stock market will follow suit – it won't. The world events and the stock market returns are two separate functions. They do not necessarily act in tandem.

If you take away anything from this paper – this is it. Don't get influenced by what you think might happen, the markets don't care what you think. I promise you.

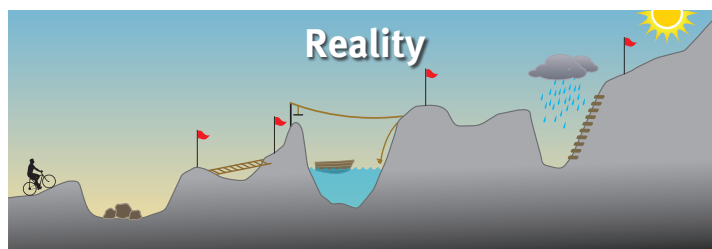
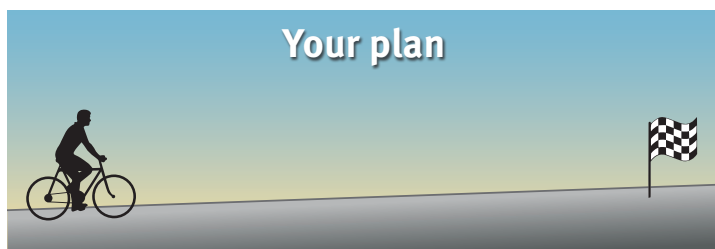
Year-Over-Year Earnings Growth from March 31, 1927, to September 30, 2003	
Profit Change	Annualized S&P 500 Return
Above 20%	1.3%
20% to 10%	5.8%
10% to -10%	9.3%
10% to -25%	28.6%
-25% and below	-28.2%

The greatest stock market gains have come when come corporate profits have dropped -10% to -25%.

Confusing strategy and outcome. Perhaps it's human nature to judge the correctness of a strategy only by its outcome. In reality, since we cannot predict the future, a strategy is either correct before the fact (before the future is known) or it is not. Consider the case of a family breadwinner with a spouse and children to support. Unless the family is independently wealthy, life insurance is almost always a part of a prudent financial plan. Yet we don't judge the correctness of this decision by whether the beneficiary collects on the policy. Purchasing insurance is a sound strategy, regardless of the outcome. One cannot judge a performance in any given field (war, politics, medicine, investments) by the results, but by the costs of the alternatives. (i.e., if history played out in a different way) Clearly the quality of a decision cannot be solely judged based on outcome.

The Language of Risk

Build a process to decide how much and what kind of risk to take.



RISK ...

What is risk? Risk is a misunderstood concept, with no clear conceptual or quantitative acceptance of what it is, let alone how it could be measured or even managed. A topic that deserves a full understanding.

Risk is clearly a multi-faceted concept, that means:

- Different things to different people
- Different things to the same person at different points in time

How do we define and measure risk?

Most people use ad hoc rules, with many arbitrary restrictions (sectors/weights/countries/asset classes). There are too many “statistical” risk factors. It is important to make a distinction between risk *measurement* and risk *management*.

Match risk to time horizon

Spend it prudently:

- Risk enhancers
- Volatility reducers

Risk management – budget risk

- Determine appropriate level of risk
- Select the types of risk to own
- How do you spend your risk?
- Avoid unintentional risk – know the risk that you are taking
- Size risk exposures appropriately
- Risk should be deliberate, intentional, diversified and appropriately scaled
- Seek a high risk/reward process
- Get clear on what risk means to you

Risk monitoring – manage the journey

Exit losing trades and let the upside take care of itself. Don't get caught in the noise. Know where your risk comes from.

The desire for certainty

Some risks are unknowable. We live in a world of probabilities – not certainties. Volatility is a short term phenomenon. Comfort can be expensive.

Against this background there is a very clear demand for financial decision making to become structured, disciplined, justifiable and repeatable.

Risk can be real. A large negative surprise.

One need look no further than September 11, 2001 for proof of an important point.

By accepting the real potential for significant negative surprises, you will be much better prepared to cope with them should they actually occur.

Only investment risk matters for making decisions, particularly for long term portfolios. But all risks are emotionally interconnected and it requires considerable effort to pull them apart. Correctly label each component. Investors being over emotional, advisors fearful of business risk and the real investment risk. Carefully distinguish between emotions and investment risk - you could find yourself wealthy.

You only mitigate market risk by not being in the market. Be in market or don't, but if you are willing and wanting then accept it and invest intelligently in the areas that have shown to have the highest benefits. Don't water down your investments with short term emotional adjusting. Think one percent.

Regardless of how investment risk is defined, it's unlikely that human nature is going to change. No matter how much data and logic is applied - human emotions are still prone to overwhelm - at inappropriate times.

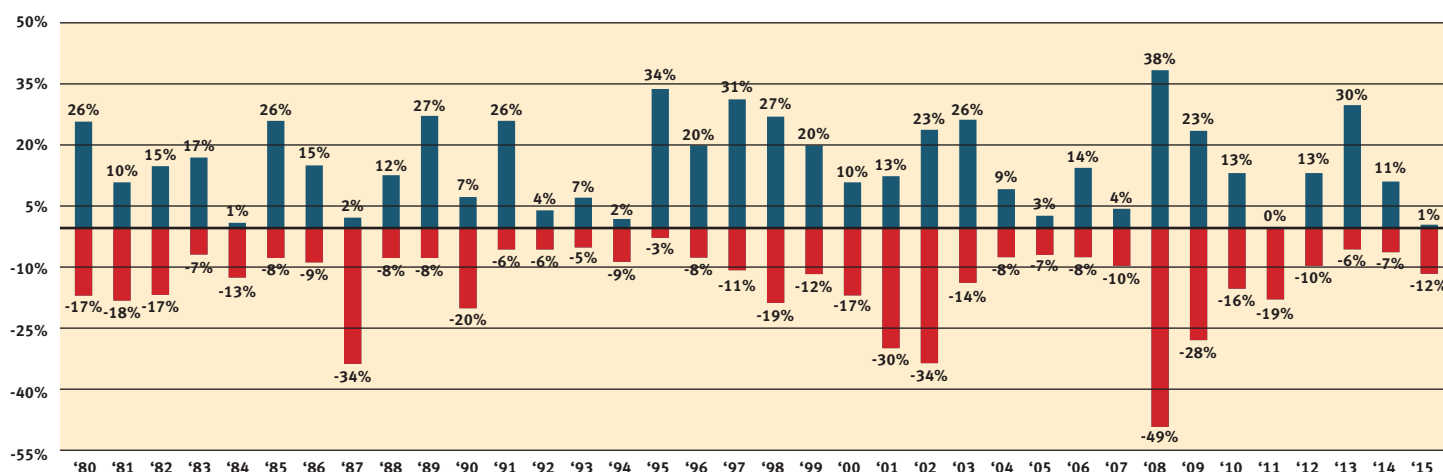
Define your risk and then own it. It will test your resolve. Move your money into alignment with its purpose, and don't put the emotional balance sheet ahead of the financial one.

Conclusion

Ample evidence supports the argument that emotional crowds dominate market pricing and volatility. As a step towards overcoming these emotional challenges, it is important to carefully distinguish between emotions and investment risk when constructing portfolios. To accomplish this, redefine risk as the chance of underperformance rather than as short-term volatility. Focus on the process rather than on the emotional path to the outcome because the process can be controlled.

Investors tend to see short-term volatility as the enemy. Volatility may lead many investors to move money out of the market and “sit on the sidelines” until things “calm down.” Although this approach may appear to solve one problem, it creates several others:

- 1) When do you get back in? You must make two correct decisions back-to-back: when to get out and when to get back in.
- 2) By going to the sidelines you may be missing a potential rebound. This is not historically unprecedented; see chart below.
- 3) By going to the sidelines you could be not only missing a potential rebound, but all the potential growth on that money going forward.



■ Intra-Year Declines vs. ■ Calendar Year Returns

Volatility is not a recent phenomenon. Each year, one can expect the market to experience a significant correction, which over the last three decades has averaged approximately 14%. Although past performance is no guarantee of future results, history has shown that those who chose to stay the course were rewarded for their patience more often than not.

The benchmark used for the above chart is the S&P 500 Index. Source: First Trust Advisors L.P., Bloomberg.

IT WORKS UNTIL IT DOESN'T



About The Author

Gregg Haglund has been a Financial Advisor since 1991 and a Portfolio Manager since 1996.

Gregg provides quality investment advice and his portfolio management skills to other financial advisors for use with their clients, as well as personally for a select group of his own clients. He is a student of the markets and from time to time authors timely industry related articles when warranted. Gregg finds that being a Fiduciary Standards of Care Portfolio Manager in addition to a Financial Advisor allows for greater transparency with his clients as the management of their assets is not “delegated” to third parties or products elsewhere.

This empowers Gregg with a greater depth of knowledge of his clients’ assets and the ability to provide timely insight on alignment with the realities of the markets.

Gregg L. Haglund

First Vice President - Investment Officer
PIM® Portfolio Manager

Wells Fargo Advisors

225 S. Lake Ave., Ste. 700

Pasadena, CA 91101

Tel 626-583-4139

Fax 626-449-9564

gregg.haglund@wellsfargoadvisors.com

gregghaglund.com

[linkedin.com/in/gregg-haglund-02420319](https://www.linkedin.com/in/gregg-haglund-02420319)



Wells Fargo Advisors did not assist in the preparation of this report, and its accuracy and completeness are not guaranteed. The opinions expressed in this report are those of the author(s) and are not necessarily those of Wells Fargo Advisors or its affiliates. The material has been prepared or is distributed solely for information purposes and is not a solicitation or an offer to buy any security or instrument or to participate in any trading strategy. Additional information is available upon request.

The PIM program may not be appropriate for all investors. Please carefully review the Wells Fargo advisors advisory disclosure document for a full description of our services. The minimum account size for this program is \$50,000.

Wells Fargo Advisors is a trade name used by Wells Fargo Clearing Services, LLC. Member SIPC, a registered broker-dealer and non-bank affiliate of Wells Fargo & Company.