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Making “Risk” Relevant

“Risk” is a word portfolio managers (including yours truly) sometimes toss about too casually, as if expecting our audience to grasp its meaning by the context of what we’re discussing. This can get confusing when we change contexts and suddenly seem to be contradicting the very notions of risk we’d described just moments before. And it doesn’t help when we sprinkle in references to mean-variance, utility functions, or leptokurtosis!

Let’s try some plain talk. Broadly speaking, we can define risk as the chance something might go wrong. But what is the “something” that “might go wrong”? Here we cannot generalize.

To the contrary, what constitutes a risky approach in one instance can be the safe path in another, and vice versa. An investor needing full liquidity at a known amount in one month should regard stocks and bonds as risky, and cash as a refuge. On the other hand, an investor putting aside money for 20 years should seek to *minimize* cash holdings given the likelihood that inflation and taxes will erode their real value over such a long period; stocks and bonds are less likely to “go wrong” when we’re considering terminal value two decades hence.

How can it be that in the first instance cash promises safety, and in the second it threatens hazard? How can two fistfuls of dollars have opposite probable outcomes?

Part of the answer is that *risk does not reside in the assets themselves; rather, it resides in how we try to make use of them*. Moreover, its nature changes with the matter of “when.” As economist Peter Bernstein has written, “Time transforms risk.” We cannot isolate risk from time horizon.

Popular intuition and professional risk metrics alike focus on the interim volatility of investments (how market values jump about). But a long time horizon can demote volatility to mere distraction or annoyance, something that only becomes a danger if it entices or frightens you into making ill-

timed allocation shifts against strategic policy, such that you end up buying high or selling low.

Volatility itself need *not* equate risk. Robert H. Jeffrey, who first ran a manufacturing company and then an investment company (and who thus has had that unusual experience of wrestling risk in its tangible as well as its financial manifestations), has put it this way:

“Volatility per se... is simply a benign probability factor that tells nothing about risk until coupled with a consequence.”

I’d prefer to say that volatility is not benign, nor is it malign – rather, it’s indifferent – but Jeffrey still gets right to the meat of the matter. What counts, what makes all of this relevant, is the *consequence* of success or failure in meeting your portfolio’s goals regarding actual liquidity events – those times when you want your portfolio to provide cash for spending or giving, i.e. when it’s time for your wealth to come off the account statement page and into the world.

Here’s what I want. When you and I sit down to discuss investment policy and portfolio risk, let’s talk first not about assets, but about YOU, or more specifically *what you are trying to accomplish* and *when you want to accomplish it*. And let’s add a corollary question tying back to Jeffrey’s point about consequence: *what happens if you don’t accomplish what you set out to?*

Until we tackle these questions, discussing particular investments may make for an interesting conversation, but it won’t make for a relevant one.

Defining your portfolio goals vis-à-vis ongoing or eventual uses of cash is hard work. It demands introspection. It demands that you set priorities. Sometimes it demands that you face certain fears. But it simply must be done, because done right it can also unburden you of worry, and free you to pursue what you most want in your life, and what you most want for your family or community.

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