FINANCIAL ROAD WORK

BY KEN BELLAVANCE

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BULLS, BEARS, AND BUBBLES

UNDERSTANDING UNCERTAINTY AND THE RISK/REWARD DILEMMA OF INVESTMENTS

Most people have heard of the relationship between risk and reward. If I open a restaurant, I'm taking a huge risk, and it is very unlikely that it will pay off. My only hope for running a profitable restaurant is to somehow benefit from my complete incompetence in the culinary arts. Absolutely no one else would have food that tastes as 'unique' as mine; therefore, maybe I benefit from the originality. While that outcome is highly optimistic, history and reality would tend to lean towards my restaurant being a complete failure.

So how do you identify risks associated with investments? At the heart of every investment lies a company or government institution. Sometimes, multiple companies or institutions can be placed within an investment. The success of the investment will hinge on the current financial stability, news, and future outlook of that organization. Outside of the company's control, overall economic conditions will affect the company's performance and investment potential. Let's look at a fictional example with Josh and Apple Inc.

- Apple Inc., the company behind the iPhone, iPad, iPod, and Mac is a well-known tech company in the United States and around the world. Josh buys one share of Apple Inc. for $10 (I told you it was fictional). The future value of that one share will hinge on many different factors and questions. Will Apple sell more products than anticipated in 2015? What if China's economy slows down and iPhone sales are affected? Will Apple's rival, Google, capture the automobile industry's entertainment systems? Will the iPhone 7 have severe technical issues, or will it be a complete success? Along the way, the value of Josh's one share will fluctuate every time news breaks, good or bad.

My example highlights some of the main types of risk associated with investing. Each type of risk has a fancy title and definition found on FINRA's website. For more details, check out FINRA's webpage for Managing Investment Risk.

Today, the general sentiment among investors is that there seems to be more risk than reward. The Dot-Com bubble popped in 2000, and more recently, the Housing bubble popped (AKA subprime mortgage crisis) in 2007. Both events sent the economy into a recession and created what is known as a "Bear" market in the investing world. A Bear Market is in effect when investors are pessimistic about the economy and they anticipate companies to have losses or decreased revenues. A "Bull" market is in effect when investors are optimistic about the future and stock prices are either rising or expected to rise.

The way you manage risk is by looking at history, assessing your own tolerance for risk, determining current economic trends, tracking progress towards your goal, and establishing a time horizon for the investments. While that sounds like a lot of work, it's actually a simple process.

First, history does not guarantee future success, but it does provide evidence for similar economic trends and cycles. Historically, Bull markets (good times) have lasted longer than Bear markets (bad times). For the visual learners, here is a historic chart of the S&P 500 index. The *S&P 500* is not a Nascar race (I'm not 100% on that), it is an index or measurement of 500 large companies representing the leading industries in the United States. It is safe to say the S&P 500 is a good representation of how well large companies have fared in the U.S.

Before investing, everyone should understand how high or low their tolerance for risk is. A good way to find out your tolerance is to fill out a questionnaire with hypothetical situations. For example:

- If your investment portfolio decreased in value by 15% in the time span of two months, what would you do? Assuming you have 10 years before withdrawing the funds.
    - A) I would immediately request to change my investments.
    - B) I would wait three months to see if the trend reverses before making a change
    - C) I would wait at least one year before making a decision about a change
    - D) I would not make a change.

Risk tolerance assessments will include different variations of the question mentioned above. Financial Advisors should present their clients with some form of a risk questionnaire. Ultimately, investors are going to be more comfortable over the long term with investments that better reflect their tolerance for risk. If an investor has a high tolerance for risk, and 30 years for the money to be invested, they may be disappointed in the results of a very safe investment such as U.S. Government Bonds.

Determining risk tolerance and investment selection is always viewed through the lens of *time horizon.* Time horizon is the length of time an investment will be held before it is liquidated or sold. Think about the purpose of the investment and how your plans might change over time. If you are investing for retirement, at what age do you want to retire and how long do you want your retirement assets to last? If you are investing for college education, when do you plan on starting school? Are you going to pay for the first two years out-of-pocket and use investment funds for the last 2 years (sorry super-seniors)? Each time frame should adjust how much risk you take with your investments. Generally, the less time you have the less risk you should take. For investors that have more time before the funds are needed, you may be able to take more risk. Check out FINRA's webpage for Investing for Different Time Periods.

The purpose of investing is to hit your goals, right? You want to retire comfortably. You want to pay for tuition expenses. Therefore, if you are at or near your goal, it is wise not to take on too much risk. Regardless of your risk tolerance, celebrate the fact you have hit your goal by investing in assets that will preserve your total account balances. The process of adjusting your portfolio to reflect your desired level of risk and asset allocation is called *rebalancing.*

Challenge yourself and your financial advisor to construct a plan that will account for your specific preferences. There is no such thing as a "one size fits all" approach. Understanding risk will go a long way towards achieving your financial goals.

Any questions, whether they be situationally specific, hypothetical, or completely off the wall, can be directed to my email at ken@investplanadvise.com or call me 770-205-4394. When emailing, please include appropriate contact information.

MEET THE AUTHOR

Ken Bellavance

Ken Bellavance studied Finance at the University of North Georgia as a student/athlete. Ken graduated at the top of his class from the Mike Cottrell School of Business and received the Excellence in Finance award for his academic efforts within his field. After four years of college baseball, Ken ended his playing days as an Academic All-American.

As a professional, Ken worked at Provident Funding Associates as a Credit Analyst in the wholesale mortgage industry. He was able to develop a unique skill-set by participating in the mortgage lending process.

Ken and his wife Danielle live in Cumming, GA. They take full advantage of the beautiful North Georgia mountains by kayaking, hiking, and fishing. Being from Stone Mountain, GA, Ken is a Georgia Bulldawg, Atlanta Braves, and Atlanta Falcons fan. He also enjoys losing less than 10 golf balls when he plays a round of golf.

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