Perspectives

The Number One Risk to Your Portfolio is You

By Jerry A. Miccolis | Posted: 03-16-11 | 08:43 AM | E-mail Article

Recent financial market turbulence has forced investors across the spectrum to come to grips with risk – what it means for them, their portfolios, and their life plans.

The days of building a nest egg by buying and holding blue-chip stocks are long over. Long-term investing is still the key, but to grow your wealth, your financial plans must be carefully thought out, your portfolio should be broadly diversified, and your assets allocated in line with your long-term needs.

With the best of intentions, however, an investor can still end up with a low-growth portfolio. For many investors, the biggest obstacle to long-term growth is not the markets: It's their *own behavior*.

Why Investors Underperform the Indices

The drama in the financial markets over the last 24 months has left most people feeling as if their worst enemy is market volatility. Their reaction has been to move their money to bonds or cash.

Given the long-term effects of inflation, this is precisely the wrong thing to do. Down the road, your portfolio will likely *lose* value – its purchasing power shrinking due to the effects of inflation.

Market volatility is not a bad thing, if you know how to exploit it to your advantage through enlightened asset allocation and systematic rebalancing.

Over the last 20 years – which included the so-called "lost decade" for investing – the average annualized return for S&P 500 index funds was approximately 8 - 9%. At the same time, the average *investor* in equity funds received only an annual return of approximately 3 – 4%, according to the latest *Quantitative Analysis of Investor Behavior (QAIB)* study by DALBAR, Inc., an industry research firm.

Why such dramatic underperformance? Left on their own, investors will tend to get into and out of the markets at exactly the wrong times. It is simply human nature to abandon the stock market when it is in decline and be drawn back in when it is on the rise. This leads to the classic counter-productive behavior of selling low and buying high. Investors typically let their emotions get the better of them and can't get out of their own way.

Embrace Risk – Make a Friend of Volatility

So, how can investors overcome their self-destructive tendencies and make the most of the opportunities the market has to offer?

Turn off your emotions. Instead, look at the investents in your portfolio as a set of risky variables that can be played off one another to get a long-term positive result.

Be methodical. Construct a financial plan using a lifetime cash-flow projection, design a diversified portfolio with assets properly allocated to exploit their dynamic behavior, and rebalance frequently to stay true to your desired allocation and achieve higher returns with no increase in risk.

Build in protection. Sophisticated investors add explicit protection against sudden portfolio declines. For many investors, this allows them to stay in the markets while still enjoying a good night's sleep.

What Not to Do

Chase the latest hot stock. Don't get too excited about what you're hearing from the "talking heads" in the financial news media. By the time the media starts talking about a high-performing stock or sector, it's probably no longer a smart investment. And, just because performance in a particular stock or industry sector may have had a good recent run, there's no guarantee that will continue. One of the truisms of smart long-term investing is: If you are reblancing reguarly, you'll be selling hot performers as everyone else is rushing to buy.

Try to "time" the market. Trying to become an active manager who aims to "time the market" implies that you can beat the stock market averages by knowing what to invest in, and when. This is simply untrue: Studies have consistently shown that market timing and active management strategies do not perform as well as the market indices over time. Isolated successes are usually the result of luck, and don't add up to strong performance over the long term. A portfolio based on informed asset allocation and systematic rebalancing has a better chance of growing over time to meet your needs.

Underestimate the power of inflation. If you are like most investors, your portfolio needs to be working for you for several decades. Over that time horizon, the biggest risk to your financial future is inflation, not short-term market volatility. Inflation is an incessant, insidious eroder of wealth – its impact can be devastating to your long-term plans. Don't be so nervous about the short-term, by being overly conservative in your investments, that you surrender the long-term battle against inflation.

Making the Most of the Markets

If you make volatility your friend, and avoid letting your emotions get in the way, you have a better shot at making the most of the opportunities the markets have to offer.

Investing is no longer simple – you may need a trusted advisor on your side who can help establish the best financial plan, and navigate the way to constructing a portfolio that will work for you.

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