How Do You Measure Risk?

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It's relatively easy for most people to understand and measure returns – did you make money or not? Measuring risk, however, isn't as well-understood. Financial professionals evaluate risk by analyzing several factors including standard deviation – a measure of how variable the price of a stock or bond has been throughout history. A stock which has experienced large swings in its price is considered to have more risk than one where the price has been relatively stable. It's one thing to know you earned a 10% return on your portfolio, but, do you understand how much risk you took in order to achieve that return? In a bull market, the average investor tends to focus more on returns and less on risk. However, in a bear market like we're currently experiencing, the negative consequence of risk becomes obvious.

How many of you associate risk with the type of asset you're invested in (e.g. bonds are a safe investment)? How many of you lost money in bonds last year? The risk of a particular asset class (e.g. stocks, bonds, real estate, etc.) changes over time based on price. In the case of bonds, in response to COVID, central banks lowered interest rates to levels approaching zero which forced bond prices to all-time highs. The risk of owning bonds increased as the price of bonds increased. Stated another way, buying a 10-year bond that only paid you 0.5% interest wasn't a good risk-adjusted return. As shown below, if you bought US government bonds in the early 1980's, the coupon (interest rate) you received would have been over 10% compared to that same bond paying you less than 2% in 2020-21.

Source: NBF, www.macrotrends.net

Understanding that the risk of a particular asset class changes over time based on price is key to managing the risk of your portfolio. For example, history has shown that investing in the stock market when it's trading at 15 times earnings will provide a superior risk-adjusted return relative to investing when it's trading at 25 times earnings.

Please call one of our advisors for a free, independent evaluation of your portfolio and how much risk you are taking.

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