THE RISK OF RISK

by

JAMES FALCONE
Managing Director, Fulcrum Wealth Advisors

THE RISK OF RISK

"We have met the enemy and he is us"

-Walt Kelly

Having spent over the last 25 years advising Boeing employees about their personal financial planning and investment needs, I find myself in a unique position to offer the following perspective. The one consistent theme of almost everyone I have ever met is - they don't like to lose money. An earth shattering perspective I am sure. When asked to define risk, in my experience, many people may simply offer – "losing money." I have read an uncountable number of studies, and I suggest you do so as well, on the concept of Behavioral Finance. In a nutshell, the studies suggest that the average person tends to be terrible at managing their own investments because they are too emotional attached to it. The typical Boeing retiree I hazard to say is no different. People recognize the need to invest but not how to do so with less trepidation.

The biggest challenge of our investing lives is not finding better ways to time the market, or even ways to process information more effectively therefore giving ourselves a chance to beat the market. Our biggest challenge is finding the courage to focus on what matters, to admit that our emotions tend to be a hindrance to our investment decisions, and to recognize that our investment discipline suffers mightily at the hands of such fears.

I have created many hundreds of financial plans for Boeing employees over the years and have always strived to help them understand the complexities of the global investment market as it relates specifically to them and their tolerance for risk. More on this later. So…

<u>What Is Risk?</u>

All investments carry some degree of risk. Stocks, bonds, mutual funds and exchange-traded funds can lose value, even all their value, if market conditions sour. Even conservative, insured investments, such as certificates of deposit (CDs) issued by a bank or credit union, come with inflation risk. They may not earn enough over time to keep pace with the increasing cost of living.

I found a wonderful synopsis of concept of risk on the Financial Industry Regulatory Authority (FINRA) website and offer it here;

"When you invest, you make choices about what to do with your financial assets. Risk is any uncertainty with respect to your investments that has the potential to negatively affect your financial welfare. For example, your investment value might rise or fall because of market conditions (market risk). Corporate decisions, such as whether to expand into a new area of business or merge with another company, can affect the value of your investments (business risk). If you own an international investment, events within that country can affect your investment (political risk and currency risk, to name two). There are other types of risk. How easy or hard it is to cash out of an investment when you

The opinions contained in this material are those of the author, and not a recommendation or solicitation to buy or sell investment products. This information is from sources believed to be reliable, but Cetera Advisor Networks LLC cannot guarantee or represent that it is accurate or complete.

A diversified portfolio does not assure a profit or protect against loss in a declining market. Asset allocation cannot eliminate the risk of fluctuating priced and uncertain returns.

Investment advisor representative of, and securities and investment advisory service offered through Cetera Advisor Networks LLC, member FINRA/SIPC. Cetera is under separate ownership from any other named entity. Investment Advisory services are offered through Fulcrum Wealth Advisors, LLC. Fulcrum Wealth Advisors, LLC is a registered Investment Advisor in the State of Washington.

need to is called liquidity risk. Another risk factor is tied to how many or how few investments you hold. Generally speaking, the more financial eggs you have in one basket, say all your money in a single stock, the greater risk you take (concentration risk). In short, risk is the possibility that a negative financial outcome that matters to you might occur. There are several key concepts you should understand when it comes to investment risk." [1]

There is no way that I can properly deal with every conceivable concept of risk management in a brief paper like this, however I believe it will serve all of us to touch on some of the high points.

<u>Inflation</u>

Inflation is the rate at which the general level of prices for goods and services is rising and, consequently, the purchasing power of currency is falling. Central banks attempt to limit inflation, and avoid deflation, in order to keep the economy running smoothly.   Another way to look at this is through the concept of purchasing power. Purchasing power is the value of a currency expressed in terms of the amount of goods or services that one unit of money can buy. Purchasing power is important because, all else being equal, inflation decreases the amount of goods or services you would be able to purchase.

<u>Market risk – Beta</u>

Every portfolio has two types of risk embedded in it: diversifiable (non-systematic) risk and non-diversifiable (systematic) risk. Diversification across unique asset classes goes a long way towards risk control. However, the prevalent source of uncertainty in an investor's portfolio is the risk that is tied into the market – that is simply the risk of just being in it. While this risk can never go away, it can, however, be measured so that investors can make better decisions.

A beta of 1.0 means that for every 1% change in the market, an individual security or investment will likely move 1%. In other words, it tracks directly with the market. Stocks with betas greater than 1.0 have more amplified movements than the market itself; they have a greater level of risk. A beta, for example, of 1.4 implies that an investment's returns will likely be 1.4 times as volatile as that of the market. A beta of less than 1.0 means that the security moves in the same direction as the market, but not as far as the market. For example, a beta of .85 means that the security is 15% less volatile than the market.

The Beta Coefficient is determined by several factors: the variability of the individual investments return, the variability of the market return, and the correlation between the return on the

investment and the return on the market. Because beta is based on the historical performance of a stock, it should not be used as an indication of how the stock may perform in the future

<u>Correlation</u>

Asset correlation is a measurement of the relationship between two or more assets and their dependency. This makes it an important part of asset allocation because the goal is to combine assets with a low correlation. Another way to say it is how much of the typical price movement in one investment can be explained in the price movement of a different investment.

The correlation measurement is expressed as a number between +1 and -1. A zero correlation indicates there is no relationship between the assets. A +1 indicates an absolute positive correlation (they always move together in the same direction). A -1 indicates an absolute negative correlation (they always move together in opposite directions of each other).

The selection of investments will depend on one's tax bracket, need for current income, and the ability to bear risk, but regardless of the risk-return objectives of the investor, it is natural to want to minimize risk for a given level of return. The efficient portfolio consists of investments that provide the greatest return for the risk, or—alternatively stated—the least risk for a given return. To assemble an efficient portfolio, one needs to know how to calculate the returns and risks of a portfolio, and how to minimize risks through diversification. If you would like to see the equations for proper portfolio construction and analysis you can find much of this material online.

Most investments are positively correlated, that is between the values of zero and +1, while some offer correlation that is inverse to traditional investments. In fact, it is difficult to find investment assets that are negatively correlated to the investment markets let alone extremely so.

When people talk about "diversification" as it relates to their investments what they are really talking about is the concept of correlation. In fact, it is the only thing that really matters. Many people are used to hearing about the theory of "asset allocation" not recognizing that at it base, in fact the only reason the whole concept exists, is the mathematical concept of correlation.

A problem is that correlations are dynamic. You know the saying "Past performance does not equal future returns". This is especially true with correlations because they change. The world is becoming increasingly interconnected, so many investments that formerly had low correlations are now more correlated.

If you are going to build a proper portfolio it is important to understand you must revisit said portfolio often and determine how the correlation of your investments have changed.

The opinions contained in this material are those of the author, and not a recommendation or solicitation to buy or sell investment products. This information is from sources believed to be reliable, but Cetera Advisor Networks LLC cannot guarantee or represent that it is accurate or complete.

A diversified portfolio does not assure a profit or protect against loss in a declining market. Asset allocation cannot eliminate the risk of fluctuating priced and uncertain returns.

Investment advisor representative of, and securities and investment advisory service offered through Cetera Advisor Networks LLC, member FINRA/SIPC. Cetera is under separate ownership from any other named entity. Investment Advisory services are offered through Fulcrum Wealth Advisors, LLC. Fulcrum Wealth Advisors, LLC is a registered Investment Advisor in the State of Washington.

THE RISK OF RISK

"We have met the enemy and he is us"

-Walt Kelly

Income sources

Much of what I teach during my seminars and webinars at The Boeing Company is not just the concept of portfolio diversification but also income diversification. Old school Boeing employees, if I am allowed to say that, are very luck in that they are scheduled to receive a pension. It is very clear that corporate America is working diligently to do away with the pension as they are expensive vehicles for the corporation to maintain. With the inclusion of pension income from The Boeing Company many employees may find they have an easier time planning a successful retirement strategy.

Many people expect to have several sources of retirement income including Social Security, a retirement or savings account and increasingly a part-time job. Less common ways to pay for retirement include tapping your home equity or purchasing an annuity or rental property, according to a recent Gallup poll. Here are 10 ways to pay for retirement:

How much do you rely on each of the following sources of income today -- is it a major source of income, a minor source of income, or not a source at all?

Based on retirees

	Major source	Minor source	Not a source
	%	%	%
Social Security	59	31	9
A work sponsored pension plan	36	21	40
A 401(k), IRA, Keogh or other retirement savings account	25	30	43
The equity you have built up in your home	16	28	53
Individual stock or stock mutual fund investments	14	26	58
Annuities or insurance plans	12	21	65
Other savings such as a regular savings account or CDs	8	43	47
Rent and royalties	8	13	76
Money from an inheritance	6	16	75
Part-time work	3	17	77

April 9-12, 2015

GALLUP

The opinions contained in this material are those of the author, and not a recommendation or solicitation to buy or sell investment products. This information is from sources believed to be reliable, but Cetera Advisor Networks LLC cannot guarantee or represent that it is accurate or complete.

A diversified portfolio does not assure a profit or protect against loss in a declining market. Asset allocation cannot eliminate the risk of fluctuating priced and uncertain returns.

Investment advisor representative of, and securities and investment advisory service offered through Cetera Advisor Networks LLC, member FINRA/SIPC. Cetera is under separate ownership from any other named entity. Investment Advisory services are offered through Fulcrum Wealth Advisors, LLC. Fulcrum Wealth Advisors, LLC is a registered Investment Advisor in the State of Washington.

- *Social Security.* Social Security is the most common source of retirement income, with 88 percent of retirees saying they rely on the steady stream of payments and 59 percent calling Social Security a major source of their retirement income, Gallup found. Just under a third (31 percent) of workers think Social Security will be their primary way of paying for retirement, but another 51 percent of employees are still counting on Social Security to be at least a minor source of retirement income.
- *Retirement accounts*. Prior to the recession, over half (59 percent) of workers planned to rely on a 401(k), IRA or other retirement account as their primary source of retirement income, but that number has since fallen to 31 percent in 2014. Even fewer retirees (25 percent) use retirement accounts as a major source of retirement income.
- *A pension.* Just over a third of retirees (36 percent) say that traditional pension payments are a significant source of their retirement income. Even fewer workers are expecting a steady stream of payments from their former employer in retirement
- *Home equity.* Some 16 percent of retirees are using the equity they have built up in their home to help pay for retirement, perhaps using a reverse mortgage or by significantly downsizing and pocketing the extra cash. About the same proportion of workers are hoping that home equity will give their retirement finances a boost.
- *Stocks*. Just 14 percent of retirees say a significant chuck of their income comes from individual stocks or stock mutual fund investments. About twice as many workers are hoping the stock market will give their retirement income a lift, Gallup found.
- *Annuities*. An immediate annuity allows you to get a pension-like stream of steady payments throughout your retirement in exchange for handing over a chunk of cash up front. But only about 12 percent of retirees say they have bought an annuity or other type of insurance plan as a retirement income strategy, and just 7 percent of workers plan to do the same.
- *A savings account*. Only 8 percent of retirees say a savings account or CD is a place they keep the majority of their retirement income, although 36 percent consider it a minor source. But 43 percent of workers expect these FDIC-insured accounts to hold a significant portion of their retirement money, and another 47 percent say it will be a minor source of funds.
- *A part-time job*. Many workers expect a part-time job to be a major (3 percent) or minor (17 percent) way they pay for retirement.
- *Rent and royalties*. Income from a rental property or intellectual property can be used to help pay for retirement by the people who have this option, which includes 8 percent of retirees and another 7 percent of workers.
- *An inheritance.* While a large inheritance could boost your retirement prospects, it's probably not a good idea to count on receiving one.

The opinions contained in this material are those of the author, and not a recommendation or solicitation to buy or sell investment products. This information is from sources believed to be reliable, but Cetera Advisor Networks LLC cannot guarantee or represent that it is accurate or complete.

A diversified portfolio does not assure a profit or protect against loss in a declining market. Asset allocation cannot eliminate the risk of fluctuating priced and uncertain returns.

Investment advisor representative of, and securities and investment advisory service offered through Cetera Advisor Networks LLC, member FINRA/SIPC. Cetera is under separate ownership from any other named entity. Investment Advisory services are offered through Fulcrum Wealth Advisors, LLC. Fulcrum Wealth Advisors, LLC is a registered Investment Advisor in the State of Washington.

THE RISK OF RISK

"We have met the enemy and he is us"

-Walt Kelly

Financial planning

In my opinion, a sound financial plan is the axle on which one's entire financial life turns. In fact, it is so important that I refuse to work with anyone who is not willing to spend the time to work through this process. It is through the financial planning process, if done properly, where other risks may be discovered. In this context I use the term risk to define the quantitative as outlined elsewhere in this document as well as the qualitative. It is through the financial planning process where other risks like taxation, insurance risks, income risks and philanthropy, to name a few, can be brought to light and discussed. The financial planning process is more "touchy feely" as it cannot all be just about the math. I will often, tongue in cheek, tell clients that this is more of an exercise in psychoanalysis than just the math offered through a spreadsheet. Planning, and its associated documents, are where you are able to communicate to future generations of your family your value systems, faith, and/or desires. There are simply no wrong answers!

Lastly, it is important to understand that financial planning is a process not an event. A financial plan is never really done. It is a living, breathing thing up until the day you are no longer. I encourage all who read this to review your financial plan often with its creator as well as your legal and tax professionals.

1. - See more at: http://www.finra.org/investors/reality-investment-risk#sthash.OAVLDIo7.dpuf

Fulcrum Wealth Advisors
10900 NE 8th St., Suite #1000
Bellevue, WA 98004
877.400.0260
www.fulcrumwa.com

The opinions contained in this material are those of the author, and not a recommendation or solicitation to buy or sell investment products. This information is from sources believed to be reliable, but Cetera Advisor Networks LLC cannot guarantee or represent that it is accurate or complete.

A diversified portfolio does not assure a profit or protect against loss in a declining market. Asset allocation cannot eliminate the risk of fluctuating priced and uncertain returns.

Investment advisor representative of, and securities and investment advisory service offered through Cetera Advisor Networks LLC, member FINRA/SIPC. Cetera is under separate ownership from any other named entity. Investment Advisory services are offered through Fulcrum Wealth Advisors, LLC. Fulcrum Wealth Advisors, LLC is a registered Investment Advisor in the State of Washington.