Ep21: Risky Behavior

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PATTI BRENNAN: Hi, everybody. Welcome back to "The Patti Brennan Show." Whether you have $20 or $20 million, this show is for those of you who want to protect, grow, and use your assets to live your very best life.

Joining me today is Brad Everett. Brad is our chief investment officer. Brad, welcome back to the show.

BRAD EVERETT: Thanks, Patti.

PATTI: We're going to be talking about a lovely topic, and that's all about risk. Risk is, for those of you who are listening, it is everywhere around us. How do we manage it in such a way so that it doesn't overwhelm you? How do we manage it in such a way so that it doesn't overwhelm the portfolio?

How do we make sure that we're taking the right kinds of risk to accomplish your financial objectives? What we thought we'd do today is just help to define the things that we look for as we're choosing different types of investments. We're going to break this up into three segments.

The first is, the risks involved in fixed income investments – bonds. You don't think of bonds as being risky, and yet there are definitely things we are looking for to make sure that we reduce or eliminate as much of it as we possibly can.

Then we're going to be talking about stocks. Of course, that's what everybody thinks about. It's the risk of losing money in the stock market. Well you're going to learn today that there are other types of risk that are as important and sometimes even more devastating to the quality of your life than just stock market risk.

That's going to be the third segment. That is the risk of life and your financial affairs not being what you would hope that they would be. So what can we do to make sure that you're able to accomplish the things that you want to accomplish, minimize the risk as much as possible, and make sure that you're doing the things that you need to do to live your very best life?

Brad, let's start out with fixed income investments. Fixed income investments could be bond investing, it could include other types of investments like preferreds and things of that nature. We won't get into the weeds on that stuff. Let's just talk about what you look for when you're investing in those types of instruments.

BRAD: I guess to start, we kind of look at risk maybe not as such a negative thing. I think a risk is more of an exposure. A lot of times we think of risk as just something that can go wrong, or a downside. Any of these things that we're going to talk about, and anything that we look at as a risk, can work for you as well.

Anything that seems negative, the opposite is usually true too. It's not usually like the risk of getting hit by a bus is all bad or neutral.

PATTI: Although, it's not great. [laughs]

BRAD: Not getting hit by a bus is neutral, and getting hit by a bus is bad. Usually, with investing, interest rates rising could be good or bad, and then if you've identified interest rates rise is bad then interest rates going down is probably good. There's a whole spectrum in between.

PATTI: That's a really good way to start off. What you've just identified is a thing we call interest rate risk. That is when interest rates go up, bonds lose value. Right?

BRAD: Sure.

PATTI: We take a look of where we are in the economic environment, listen to what the Fed says and say, gee, is it likely that interest rates are going to go up or down? How can we position the bond part of the portfolio accordingly?

BRAD: Sure.

PATTI: Of course, it's always going to be difficult to know for sure what's going to happen, which is where the magic of diversification comes into play.

BRAD: An interest rate risk is like, if I'm going to commit to a company's bond for 10 years, and it's going to pay me five percent a year, and pay my principal back in 5 years. If interest rates all of a sudden go up to seven percent, my bond is not going to be very appealing anymore. No one's really going to want to buy that.

I can sell that and go out and buy a new seven percent bond.

PATTI: Why would I want to buy your bond at five percent when I can get a brand new one at seven?

BRAD: Sure. Yep. The act of having locked into that payment stream is...you're committing to the next 10 years of receiving that payment. Again, rates could go down and you would find that your bond was actually very valuable. People would love to buy into your five percent income stream.

That's what we think of as interest rate risk.

PATTI: Exactly. Let's talk now about this idea of liquidity risk. This is often what you find in, for example, high yield bonds. They're just so many high yield bonds out there. What makes a market is for every seller, there has to be a buyer.

Well, what happens if the economy is going through a really rough patch, and these high yield bonds are with companies that are teetering on the brink of not being able to make a payment, and as a result you want to sell your bond, but nobody wants to but it.

BRAD: Yeah. Exactly right. That is definitely a risk. Oftentimes, the thing to be cognizant of is which of those risks work together. You would hope that the time that the economy is bad, and you have no liquidity in your bond, is not the time that you need money.

You want to use the investments that have the potential to be liquid at times like that. You want to be in the situation where that's not the money that you need because you'll be forced to sell it. Probably, really bargain base on the prices that you don't want to have to liquidate at that time.

PATTI: That plays really well with this financial risk. Even if the whole market isn't going down, a particular company might be going through some financial difficulty, and they may not be in a position to be able to pay those interest payments.

Again, folks, for those of you who are listening, let me keep this real simple for you. Bonds represent debt. Stock represents ownership. If you have a bond with a company, or a municipality, or the federal government, you have lent that entity $10,000.

For that loan, they're going to pay you five percent over the period of time, whether it be 10 years, 20 years, 30 years.

Eventually, at the end of that horizon, they're going to give you your money back. The thing that people often don't realize is that bonds trade four times more than stocks do. The bond market is huge. People buy and sell bonds all day long, worldwide.

It's a huge, huge market. Again, you've got to understand that each company and each industry may go through some challenges, and you want to make sure that you don't own their debt. Right?

BRAD: Yeah, exactly. I think financial risk, with a personal example, it's pretty easy to see how it works. If you're an individual that makes $50,000 a year, you can probably get a credit card. If you go up to 100, you'll find more credit card companies that are more than happy to give you another credit card.

Same for when you get to 150 and 200, and all the way up. All of a sudden, people will give you $100,000 worth of credit card debt, but you're not going to lose your job gradually. You're going to lose your entire job, and you're not going to be able to payback any of them. Not just the new ones that were issued to you.

The same thing works with a company. When they fall on hard times, more than likely, they're not going to give you a little bit back, they're going to give you none of it back. That's how financial risk builds into the...It can sneak up on you when times are good, and they just borrow more and more and more because it's appealing.

They don't have to issue stock and dilute shareholders. Again, they can borrow, and the owners still have their ownership bucket. When the cycle reverses, and companies aren't doing very well, they can...

PATTI: You've brought up a really important point. It's really hard to pick the debt, for you to choose where you want your debt instruments to be with. In other words, things can be rosy today, but unless you're reviewing those balance sheets on an ongoing basis while you still have that bond, you're not going to know if they're going through financial difficulty.

You're not going to know if you're really taking a lot of risk with that $100,000 that you've invested in that bond. That's why the value of diversification, and frankly, professional management, really comes into play. It has become a very, very complicated world out there, and it's difficult to stay on top of these things.

Things can happen out of the blue that you just don't anticipate, can't anticipate. Think about General Motors. You know, Brad, I often use that as example. General Motors, in 2008, went bankrupt. They went bankrupt. Yes, they had to pay back their debt, but let me tell you something, folks.

The people who held the bonds got pennies on the dollar. If you had common stock, remember, bonds represent debt, stock represents ownership. If you had General Motors stock, you lost all of your money.

They go into bankruptcy. They come back out. It's a brand new company. They don't have the debt. They don't have the common stockholders that they had before. They get to start squeaky clean, but you have lost everything.

BRAD: Yeah, they're still not going to pay you back.

PATTI: Exactly. That's a really important thing to keep in mind as you're thinking about where to deploy your assets. That is what risk is all about. What is this thing called reinvestment risk, Brad?

BRAD: Sure. Again, this ties back into how interest rates change over time. It's wonderful to get your five percent for 10 years. Once that 10 years is up, and you get the proceeds back, you principal, your original $50,000 investment, you have to find something to do with it again.

Just because you have this deal for 10 years, or whatever the term of the bond is, doesn't mean it's going to extend forever.

That, and you've got the ongoing coupon payments that you have to reinvest over time as well in order to really get the full rate of return on the bond.

PATTI: I saw that even with CD. We saw that in 2005 and 2006. People were getting six percent on their CDs. Great. It's wonderful if you were able to lock in for 10 years. Fast forward to 2016, and you were getting one percent.

You talk about a risk to financial security. That's a huge risk of not getting that extra five percent that you were counting on in order to be able to pay your bills. It's a really important thing to keep into consideration. Can you control it? Can you avoid it?

No. But you can manage it, and the way that you do that on your fixed income is to make sure that you have different types of debt instruments. For example, Brad, I'm going to let you give the highlights in terms of how you set up a fixed income portfolio and the different types of fixed income.

BRAD: Sure. We try to diversify across several respects. For one, like you said before, it is pretty tough to do to build a really diverse bond portfolio buying individual bonds. I think that most investors probably don't have the net worth to truly diversify across bonds.

If you find bonds with $25,000 or $50,000 minimums, you have a pretty hefty portfolio size in order to really be able to afford 20, 30, 40 different kind of bonds across different sectors in horizons, and things like that.

PATTI: Guys, I'm going to give you an insight or tip that not a lot of people know. I'm going to give it to you real as I always do on this podcast. If you're looking for a bond, sure, we could get you a bond. It could be a $50,000 bond, it could be a $10,000 bond, it could be a $100,000 bond. What are we going to do?

We're going to go out to the bond market, and we're going to look for bonds that meet certain criteria. I got some bad news for you. The ones that are available to individuals are nothing compared to the ones that are available to money managers.

Quite frankly, if I'm a bond trader, I have one of two choices. Let's say it's a $10,000,000 lot. I have one of two choices. I could call the Patti Brennans and Brad Everetts of the world, and sell this at $50,000 a pop.

If I do that, I'm not going to give it to Brad for the same price that I'm going to give it to the guy at the mutual fund company, and I can get rid of the whole thing in one lot.

Remember, these people trade. They make their earnings based on volumes, based on commissions. Let's face it, it's a time factor. They're going to call the big boys first or the big girls, frankly, and they are giving them access to the better bonds for a lower price than you and I can get.

I'd love to be able to do that for you. Again, I'm going to give to you real. We can't. We just don't have access to the paper that the big companies do. As you think about this, yes, you can ladder portfolios. Yes, you can do that, but there are risks in doing that, and you just want to make sure they understand the risk that you're taking when you do that.

Let's talk now about stock market risk. Everybody worries about the stock market. To your point earlier, Brad, that I think was so important, volatility is not lost, it's just fluctuation. What can go down can also go up. What are your longer term objectives, and over what period of time do you need to accomplish them?

We often talk about risk and return within the framework of time when we talk about the types of market risk, and the types of things that we look at when we're investing in the market. Let's talk about economic risk, what happened on Friday.

The market came out, the bond market did its gyrations, and the yield curve inverted, and the stock market plummeted by two percent. People were freaking out that the economy is on the verge of a wicked recession.

That's an economic risk, but not every company that went down in value is going to be affected by recession. Frankly, dollar stores are probably going to benefit because people can't afford Nordstrom's anymore. That's an example of a company that can actually benefit from a recession.

The fact that people are pulling in the rings, they're still going to buy stuff. It's just they're not going to spend as much. They're not going to go to the luxury type stores. Yet, everything went down on Friday. Give us another example of economic risk.

BRAD: Yeah, exactly. We look at levels of risks, and economic would be the broadest type. If a terror, if it's announced, or a terror, if is taken away, those would be broad economic risks. Oftentimes, investors don't have the time to process what exactly the result of that will be.

This thing happens, it broadly sounds negative, everything is going to drop. Then, as the dust settles people will spend time saying, "Well, this sector actually might do pretty well, this sector is probably gonna do worse than even we thought."

This will continue to adjust from there as people have time to process the actual industry specific risks and then the risk to specific companies themselves.

PATTI: It's a great example. An important point to bring out is the difference between traders and investors. The traders are going to be reacting. That's when you see those huge swings, those huge plummets, frankly down, as well as up. Friday, we lost two percent. What's happening today?

Everybody had a weekend, they did their research, etc., and guess what, the market is recovering already. That's the difference between a trading mentality and an investment mentality. We are investors. We're even bigger than that, frankly.

I don't mean bigger in the sense but we're really looking at, what do we need to do in that kind of portfolio to help them to accomplish their objectives, whether they'd be a year from now or 5 years from now or 20 years from now? How do we allocate their resources in the safest way possible?

BRAD: Of all these risks and things that we choose to be exposed to, some of them are appropriate for certain investors and some of them are just aren't. We need to know what risks every investment is exposed to or could be subject to, and go from there and figure out whether that's appropriate for an individual investor or not.

We might think an investment in an international small cap companies is great for young, aggressively oriented person, but that doesn't mean it fits somebody that needs to make up a 529 plan withdrawal next week.

PATTI: Exactly. Time horizon is really, really important. Let's talk about this thing called business risk or specific risk. How does that relate to the people that are listening today as it relates to choosing stocks, for example, or instead choosing a mutual fund or an ETF?

BRAD: Business risk is risk that's very specific to a particular company. It's risk of one bad decision by the CEO. It's risk of somehow them being the only company on a fault line, and they fall in an earthquake.

PATTI: I think your point about the one company, one CEO, how often do we hear earnings reports and the earnings...? A CEO will give their expectations, and then the next quarter they fall short of what those expectations are. If a CEO doesn't really...if they're not able to predict what their earnings are going to be just three months from now, how are we going to know?

BRAD: Right.

PATTI: Right.

BRAD: Sure.

PATTI: That's a good example of business risk.

BRAD: It could be a contract that expires that doesn't get renewed. It could be anything that affects one company in particular, but not the whole sector or the general economy.

PATTI: It could also be sector related. What about regulatory risk? What if all of a sudden…like what happened after the financial crisis when they came out with some of the regulatory constraints on banks?

What did banks do? The whole sector went down, big time. They're still recovering from that. In fact, that's lowest performing asset class, or sector, of anything that you could invest in when you look at the last 10 years.

They've had the headwinds of regulatory pressure that's affected their earnings because they're having to spend so much just to keep up with the rules.

BRAD: Another example of the specific risk is what just happened to Biogen last week. They abandoned late stage testing in their Alzheimer's treatments. The stock fell 30 some odd percent late last week.

PATTI: That's a great example.

BRAD: It doesn't affect Exxon Mobil. They couldn't care less. That's a very specific business risk that they were exposed to but nobody else.

PATTI: I think it's really, really, interesting and important to point out. When you take a look at the last five years, I think it was JP Morgan that did this. When you think about the Standard & Poor's 500, it is 500 companies. Actually, it's a little bit less than that, but let's just use 500 companies. Did you know that in the last five years, 45 percent of those companies lost value? You lost money if you invested in them.

So what is this about the S&P 500 doing so incredibly well, when only 55 percent of the companies actually had a positive return? What's the deal with that? What's interesting about that again, 45 percent of those companies lost money.

Do you know that only 3 percent of mutual funds and ETFs in the exact same asset class lost money? You choose. Do you want to be doing individual stocks or do you want to be more diversified? That's really the issue that we have with business risk or specific risk, right?

BRAD: Sure. Yeah, absolutely.

PATTI: Now let's talk about stocks overseas. What kind of risk are we talking about with stocks overseas?

BRAD: All the same ones that they have here, plus a few others. There's what you would think of as sovereign risk, or their regulatory risk, is not the same as ours.

They may be more of a government controlled business environment, or just exposed to other regulatory concerns that we are not. Maybe there's internal strife or a king or something like that.

PATTI: Yeah, look at Brexit. That has nothing to do with the United States.

There's lots of really good companies located in England and Great Britain, and yet they've got this thing called Brexit. There's a lot of uncertainty in terms of how it's going to affect the economy, and therefore, the companies that do business there.

BRAD: The currency exposure's a huge one too. As a domestically based US investor, anytime you invest in a Japanese company for example, a significant part of your return could be the fluctuation between the dollar and the yen.

No matter how well Samsung does, you're going to either have an addition from the currency, or a subtraction.

PATTI: I feel – and I don't know about our listeners – when we get to currencies, I begin to glaze over. I don't know why, I just don't get it.

Let's boil it down and give people a sense of what's happened over the last few years.

The dollar has gone up. Therefore, international stocks have not been a great place to be. Now the dollar is high – or relatively speaking, it is much higher than it used to be – if the dollar begins to go down relative to other currencies, then the opposite is true, right?

BRAD: Sure.

PATTI: Doesn't that mean that those international companies could actually be even more attractive?

BRAD: Yeah. Almost this entire conversation of risk boils down to that exact thing. All of these are things that you're exposed to that can go one way or the other.

The dollar could continue to go up, or it could turn around and they could meet somewhere in the middle, but you have to know that you're exposed to them, and that there's a component of your rate of return.

Then, knowing that you're exposed to that, you try to make an educated guess about what the path of the dollar price could be. What are the things that could cause it to continue to go up? What are the things that would cause it to continue to go down?

You try to make an educated guess based on things like that. Which of these is more likely? I don't know, but can we get to 70 percent, 30 percent? Can we be more sure than not?

PATTI: That is exactly right. Most people listening today, they don't really follow currencies, etc. For everybody listening, that's where your advisor really comes in. Where they can give you, again, boil it down to simple, figure out what you need to accomplish, and figure out which risks you're able to take.

They'll manage as much of it as they possibly can. They understand or, at least, I can speak for myself. We totally get it. We understand currency risks. We understand all of that. We're not trying to guess what the dollar's going to do in the next year, or even in the next five years.

We believe that the companies that are located in other countries, many of them are doing things better than we are.

Our economy may be strong now. The reason that the dollar went up was because the Federal Reserve was increasing interest rates. What happens when that stops? Which, it has. What happens if they begin to cut interest rates? Well, gee, that could also happen. How do you want to position your portfolio accordingly?

If it's something that you're not comfortable with, then that's when professional help can really come into play. Let's go into the risk that people experience in life, in general. We talk about it a lot. Things like purchasing power risk, longevity risk, and the risk of being risk averse.

Let's talk about that first one, the risk of being risk averse. That sounds like it's an oxymoron. Is it really a risk of being risk averse? I say yes. What do you think?

BRAD: There's a couple ways to define it. Humans, by definition, are risk averse. I think if you're faced with two options that should hopefully deliver, that you would expect to deliver the same outcome, you would choose the one that has the least risky path.

If you were faced with two outcomes that were equally risky, I would choose the one that offered the best possible outcome. It's what keeps up alive through the generations, is to be risk averse, and to avoid taking chances that we don't need to take. I think...

PATTI: You know what? I'm going to stop you right there. What you have just said is, you are the voice of a portfolio manager. That's the way a portfolio manager looks at risk. You don't want to take risk that you're not being compensated for.

When you're looking at two investments, you're going to choose the one that has the lowest risk and the same amount of compensation. In real life, that's not the way people really are, are they?

BRAD: No, you can certainly be irrationally risk averse. If you have a 40 year investment horizon, you would not choose bank CDs to fund your retirement, I would hope. That is risk aversion going bad.

PATTI: That's exactly right. What we often think about risk is the risk of loss. What about the risk of not accumulating enough to do the things that you want in life? I often talk about this. I say, "You know what? Don't confuse stable with safe." CDs are stable, but in Brad's example, do you consider that safe?

That person's not going to have what they need when they want to send their kids to college, buy that second home, or retire in comfort, and never have to look back.

BRAD: Downside risk and shortfall risk would work oppositely of each other. You could protect against the downside, but then you stand a big chance of not making enough on the upside.

PATTI: That is true also even for people who are older. A lot of people assume that, gee, when they get into their 60s and 70s, that they should not be taking any risk at all.

I beg to differ because people are living longer, and we've got this inflation risk. We've got to make sure that you maintain the purchasing power of your income for the rest of your life. A lot of people are not necessarily planning on leaving a dollar to their children. We do come across those people every once in a while.

BRAD: Every once in a while, yeah.

PATTI: Yet, that's not safe, either, because what happens if you live another year? You can't live on a dollar. We don't know how much longer we're going to live. We've got to position this and position the portfolio. If someone comes in, and has $20 million, and they need a hundred thousand dollars a year, yeah, they can be all in CDs.

By all means, have at it. You don't have to take any risk. Everything is relative based on your personal situation, what you're comfortable with, and what you need to have happen. Right?

BRAD: Yeah. You're correct.

PATTI: We've talked about longevity risk. We've also talked about this inflation risk. This risk of, gee, like in my mom's case. Brad, you know this story. When my dad passed away in his 60s, they had seven children. I'm one of seven.

They put us all through college. I went to Georgetown. They really were not able to save a lot of money for retirement. My dad retired. They had pretty much what they were going to have. Then he got sick. He got sick, and he did not live nearly as long as we had all hoped. He died when he was 66 years old.

Now, my mom was perfectly healthy. She loses his social security. Actually, she ended up taking the widow's benefit. She's got a little bit of a pension. Now, I have this nest egg that I got to make last for the rest of her life. You know, when this first happened, $3,000 a month was plenty for her. It was a lot of money for her. Yet, I will tell you Brad, she lived until she was age 83.

The world out there, Forbes and Baron's, they seem to think that I'm pretty good at what I do. I got to tell you, it was really hard to make this work for her. She was worried she was spending down her principal. It was a very, very uncomfortable and different situation. That $3,000 a month just wasn't cutting it anymore, and we had to dip into principal.

Boy, once you start that process, it becomes a flake here and there. A little bit once in a while is fine, but then that becomes a snowball. The snowball starts rolling down the hill. It's an avalanche, and she's wiped out. The most important thing is don't ever let that happen to you.

Inflation is like hypertension, right? You can't feel it. You don't know you have it, but it can kill you. That's what we talk about in terms of inflation risk, longevity risk, and investing so that it's so safe that you're not able to make the money last well into your 80s.

When you put together a portfolio for our clients – and for those of you who have advisers, your advisers are doing this as well – what are the things that you look at in terms of putting the portfolio together? How do you look at this big...? We talked about so many risks. How in the world do you keep it all straight and put together something that's going to work for people?

BRAD: Sure. Again, as I'm sure you discussed in previous episodes, we start from the financial plan. We know what the clients' goals are, how long they have until they meet these various goals and things like that, what their personal risk tolerance is and things like that and back into a list of exposures that we're comfortable with.

If it's somebody that needs some stability or cash from their portfolio, we have to consider fixed income. Within the fixed income, what risks do we want there? What kind of timelines do we need various cash flows for?

We want to diversify across time horizon. We want to diversify across credit quality. We want high quality bonds there, maybe some low quality bonds that the trade off is a higher income stream. Maybe this is a client that can afford to buy that kind of risk. We want to diversify across geographies and then look at international bonds and things like that.

Same thing with the equity side, we want to make sure we have representation from sectors that we feel are in a good spot, have a good valuation, and look good going out several years, but also to protect against us making bad decisions. Various size companies, vary geographies.

PATTI: Brad, I love what you just said, because I think it's so important for the listeners to know that we are all human beings. The most important thing is to recognize that. I believe that humility is probably one of the most important qualities that I looked for when I hired Brad many, many years ago.

I found, and research has proven time and time again, that when you get people who are overconfident, who are making those big bets, who are doing lots of trading, there is an inverse correlation. Meaning, an opposite effect with that approach to investing and the results that you get on your portfolio.

Recognize that things are going to change. There are things out there nobody can control. You watch it. You monitor. You adjust along the way. That's where you get the best outcome. To pull this together, Brad, one of the things in the themes that have come through this whole episode is that risk isn't always bad.

Risk is just...It's downside, but it's also upside. There are lots of risks out there, inflation risk, market risk, business risk, longevity risks, etc. The most important thing is recognize that these risks are out there and choose which risks are you willing to take.

What can you diversify away? What can you manage in a way where it's not going to be detrimental to your long term objectives? Then you monitor the portfolio as it relates to the goals that you've set for it. Remember, your money is a means to an end. Let's figure out what you want to do.

The Brads of the world, your chief investment officers are figuring out the best combination of investments that will get you there. If things don't go quite as we had hoped, we adjust along the way. That is what real financial planning is about. That's what financial navigation is all about.

Every financial adviser is out there doing on a day to day basis to help you accomplish your most important goals. By the way, if I could just tell you this, not everybody needs a financial adviser. This might be something that you like to do.

Whatever it is, again, getting back to the risks, understand the risks that are out there, understand how they are defined, understand how your investments are exposed to those particular risks. Look at the different ways that you can avoid or reduce those risks. Make sure the portfolio has position to do the things you want to do in life.

Brad, thank you so much for joining me today. This was a great episode. Not a fun topic necessarily, a little bit dry, but if you don't know about these things, you can't do anything about them. That's the worst that could possibly occur.

That's it for today's show. Thank you so much for joining us today. If you want to learn more about this, if you want to learn more about the tools that we use to reduce or eliminate risks, head over to the website. Give us a call if you'd like to set up a meeting.

We'll be happy to sit down with you, talk about your personal situation and do whatever we can to help avoid these risks that we're talking about today. If you're online and want to give us comments, tell me what you thought about today's show. We would love to hear from you. Until next time, I am Patti Brennan. I will see you in the next episode. Have a great day.