Passive
Capital Management

Risk Matters

The Conclusion

1) *Investment returns are a function of risk.* If you want to consistently generate higher investment returns than a benchmark then you need to consistently take more risk than that benchmark.

2) The only "free lunch" in investing is diversification. *Diversification can reduce your overall risk for a given return.*

3) *Manager-selection risk is a risk for which most investors do not get compensated* because most active managers underperform their respective benchmarks.

4) You do not need to compete with the capital markets; you need to *understand the capital markets and take advantage of what they have to offer.*

Understanding Risk

Different people will have different perceptions of risk depending upon their investment goals and priorities. Not all investment returns are created equal and returns are generally a function of risk. Capitalism and the capital markets will provide a return commensurate with the risk taken; this must be the case or else the capitalistic system would cease to exist. The question is whether or not you can achieve your investment goals and objectives by taking what the capital markets offer. In my opinion, most investors *can* achieve their investment goals and objectives by enjoying the returns of the capital markets.

An investor's ultimate goal should be to maximize their return for the level of risk they choose to take. Once you understand how much risk you need or want to take, then you need to structure an appropriate asset allocation that matches your risk tolerance. While an advisor can help you think about risk and structure an appropriate asset allocation, it is ultimately up to each individual to define risk for themselves. Someone who wants to retire at age 50 might view risk differently than someone who wants to work their entire life. Someone else might be getting ready to make a down-payment on their first house and they do not want the risk of taking on too much debt. Risk means different things to different people. It is associated with the level of portfolio volatility that you can tolerate but it can be much more complicated than that.

Most people do not *want* to take any risk; it does not sound very appealing. However, the capital markets will reward investors if they take certain types of risk, so there is an upside if you invest properly. If you do not take any risk in your portfolio then you will earn very low returns and may never have a sufficient amount of money to retire; not being able to retire is also a risk. It is important to understand the capital markets so that you take calculated risks that will reward you over time.

To help you think about the level of risk that might be appropriate for your portfolio, here is an easy-to-remember reference point:

The S&P 500 equity market index has generated positive returns over any eight year period since 1926.

There have been six-year periods and even a seven-year period during which a dollar of invested assets would have lost value if it had been invested in the S&P 500 index; however, a dollar invested in any rolling eight year period would have generated a positive return. Therefore, if you have eight years or longer before you might need your funds, then it is reasonable to allocate a meaningful portion of your portfolio to equities. If your time horizon is less than eight years, then it is prudent to invest a meaningful portion of your portfolio in high-quality government bonds. Having recently experienced the bear market of 2000-2002, we all know that markets can go down substantially over the short term. Nonetheless, over longer periods of time, I believe that capitalism will provide a return on capital commensurate with the risk taken. Please see Table 1 on the next page to understand the returns and risks associated with various asset classes.

Table 1: Investment Returns Are a Function of Risk *(Annual data from 1990-2006)*

Asset Class	Annualized Return	Worst Year	Standard Deviation*
US Large Cap (S&P 500)	10.9%	-22.1%	17.4%
US Small Cap (Russell 2000)	11.1%	-20.5%	19.2%
US Micro Cap (CRSP 9-10 Deciles)	14.4%	-27.4%	26.0%
Intl Large Cap Developed (MSCI EAFE)	6.3%	-23.2%	19.3%
Emerging Markets (Fama/French)	12.3%	-31.4%	32.0%
Intermediate U.S. Govt Bonds (Lehman)	6.4%	-1.8%	4.6%

**Standard deviation is the most common measure of statistical dispersion and it measures the variability within a dataset. The higher the number, the more volatile the returns.*
Data are from Standard & Poor, Russell Company, Lehman Brothers, Center for Research in Security Prices, Fama/French and Dimensional Fund Advisors.

Misunderstood Risks

Many people believe that investing is really about finding the next hot active manager or the next hot stock. It is important to remember that you do not need to predict the future, beat the market, or own the best funds each year in order to have a successful investment experience. In fact, if you try to beat the market there is a very good chance that you will be unsuccessful. The capital markets are generally quite efficient. Approximately 70-80% of active managers underperform their relevant benchmarks over time (source: Lipper Analytical, Charles Schwab, Vanguard) and, as a result, manager-selection risk is a risk for which you will probably not be compensated. If you choose active managers to satisfy your asset allocation needs then there is a good chance that you will actually be lowering your expected returns. It is not prudent to assume a risk if it is unlikely that you will be compensated for doing so.

Additionally, some investment managers take risks that are not understood until it is too late. Many hedge funds own illiquid investments (i.e. mortgage-backed securities) that do not trade in well-functioning markets and, as a result, these investments are not valued on a daily basis and the valuation process becomes much more subjective. This can reduce both reported and observed volatility and serve to smooth investment results. The end result is that the level of perceived risk is often much lower than the actual risk embedded in the underlying securities. It is always important to remember that returns are a function of risk. If an investment manager's returns seem too good to be true, then they probably are. More times than not, the perceived "outperformance" actually came from taking more risk in the portfolio.

What Does Risk Mean to You?

There are trade-offs that every individual needs to consider when it comes to investing. It is important not to focus solely on the potential upside in your portfolio but to also remember that volatility occurs in both directions. You may hope for strong gains but you must be sure that you are not taking undue risk and exposing yourself to significant losses.

Once you and your investment advisor understand your risk profile, then you can begin to understand how your portfolio should be allocated across various asset classes. We believe that an investor's time and money should be spent understanding risk tolerance and asset allocation, not on researching individual stocks or on trying to find the next "hot" (or lucky?) active manager. Control those things that you can control (risk, asset allocation, diversification, and costs) and do not spend a lot of resources on things that you cannot control (market fluctuations). Passive Capital Management can help you think about your risk tolerance and can structure an appropriate portfolio that will give you the greatest chance of accomplishing your investment goals.

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