Your *Trust* Matters

July 2023 Newsletter

MidWestOne™ TRUST SERVICES

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Understanding Risk

Few terms in personal finance are as important, or used as frequently, as "risk." Nevertheless, few terms are as imprecisely defined. Generally, when financial advisors or the media talk about investment risk, their focus is on the historical price volatility of the asset or investment under discussion.

Advisors label as aggressive or risky an investment that has been prone to wild price gyrations in the past. The presumed uncertainty and unpredictability of this investment's future performance is perceived as risk. Assets characterized by prices that historically have moved within a narrower range of peaks and valleys are considered more conservative. Unfortunately, this explanation is seldom offered, so it is often not clear that the volatility yardstick is being used to measure risk.

What makes volatility risky?

Suppose that you had invested $10,000 in each of two mutual funds 20 years ago, and that both funds produced average annual returns of 10 percent. Imagine further that one of these hypothetical funds, Steady Freddy, returned exactly 10 percent every single year. The annual return of the second fund, Jekyll & Hyde, alternated — 5 percent one year, 15 percent the next, 5 percent again in the third year, and so on. What would these two investments be worth at the end of the 20 years?

It seems obvious that if the average annual returns of two investments are identical, their final values will be, too. But this is a case where intuition is wrong. If you plot the 20-year investment returns in this example on a graph, you'll see that Steady Freddy's final value is over $2,000 more than that from the variable returns of Jekyll & Hyde. The shortfall gets much worse if you widen the annual return variations. This example illustrates one of the effects of investment price volatility: Short-term fluctuations in returns are a drag on long-term growth. Although past performance is no guarantee of future results, historically the negative effect of short-term price fluctuations has been reduced by holding investments over longer periods. But counting on a longer holding period means that some additional planning is called for. You should not invest funds that will soon be needed into a volatile investment. Otherwise, you might be forced to sell the investment to raise cash at a time when the investment is at a loss.

The relationship between risk and reward

In general, the more risk you're willing to take on, the higher your potential returns, as well as potential losses. This proposition is probably familiar and makes sense to most of us. No reasonable person would make a higher-risk, rather than lower-risk, investment without the prospect of receiving a higher return. That is the tradeoff. Your goal is to maximize returns without taking on an inappropriate level or type of risk.

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Understanding your own tolerance for risk

The concept of risk tolerance is twofold. First, it refers to your personal desire to assume risk and your comfort level with doing so. This assumes that risk is relative to your own personality and feelings about taking chances. If you find that you can't sleep at night because you're worrying about your investments, you may have assumed too much risk. Second, your risk tolerance is affected by your financial ability to cope with the possibility of loss, which is influenced by your age, stage in life, how soon you'll need the money, your investment objectives, and your financial goals. If you're investing for retirement and you're 35 years old, you may be able to endure more risk than someone who is 10 years into retirement, because you have a longer time horizon before you will need the money. With 30 years to build a nest egg, your investments have more time to ride out short-term fluctuations in hopes of a greater long-term return.

For help understanding the risk profile of your current investments or your individual risk tolerance, please contact your Wealth Management team at MidWestOne Bank.

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