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No such thing as risk-free investment

Commentary: Instead of looking for risk-free returns, know the risks

By Chuck Jaffe, MarketWatch

Ben is a 60-something investor who approached me recently for investing advice: "If your mother came to you and asked where she could get the very best risk-free return right now, what would you tell her to buy, or would you tell her to just keep her money in the mattress?" Ben said, hopeful that I would somehow have an answer for my family that I might not usually give the rest of the world.

He was disappointed with my response.

Bernanke's real message to investors

Fed chief Ben Bernanke spoke on the economy this week. For those of you that were listening closely, his message to investors was: "I dare you to buy stocks."

I'd tell her that there's no such thing as a "risk-free return," and that it's not some "right now" problem based on the level of the market or the lousy returns of bonds, but that it's about how risk works.

The market has raised the proverbial wall of worry to new heights, but the worriers (like Ben, for instance) would still rather lose nothing than buy in at the wrong time — a time that they feel is now despite the market's recent gains.

There is plenty to be gained by "avoiding loss," and there are strategies for that. But there is nothing an investor can do to avoid risk altogether.

Oh, investment pros use the phrase "risk-free return" to refer to Treasury yields, but they know that there are risks inherent in every strategy. And while stuffing the money between the bed springs will avoid stock-market risk, it simply exposes that money to other risks.

Ben's question was actually a statement about his understanding of risk and his ability to tolerate it.

Like Ben, most people only associate risk with loss; viewed in that light, principal or market risk — the chance that a security loses value on the open market — is the big concern.

Donald MacGregor of MacGregor-Bates, a Eugene, Ore., firm that researches judgment and decision-making, noted that "When it comes to risk, people really don't know what the beastie looks like, so they deal with it on an emotional level, and really deal mostly with the potential for loss."

Diversifying across the spectrum of risks — particularly pursuing investments that face different conditions so that their success or failure is not all tied to the same market characteristics — is widely considered the best way to build a portfolio that can be depended on over time, because it ensures that no one risk will turn into the problem that kills a portfolio.

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Instead of looking for risk-free returns, consider the risks that come with each type of investment; if you can't stomach even a temporary decline of 15%, for example, then you would not want a portfolio that is 100% equities; but if you need to generate returns of 5% or greater, you can't reach that goal entirely in Treasury bonds and money markets right now.

Balancing risks improves the chances of reaching goals without having the worst potential outcomes.

Since you can't build a risk-free portfolio, consider instead the following forms of risk, to see if you have taken a risk-balanced approach.

Market risk is the big bugaboo, the chance that a downturn chews up your money. That said, it may be better to think of this as "principal risk," because your invested capital faces market risk in both the stock and bond markets, so someone who gravitates toward safe havens like bonds thinking they will avoid "market risk" has misjudged the situation; a change in the conditions of the bond market could put their principal in jeopardy, particularly if they bought bond funds rather than holding the paper themselves.

Purchasing power risk , or "inflation risk," is widely considered to be the "risk of avoiding risk" — the opposite end of the spectrum from market risk. It's the possibility that you are too conservative and your money can't grow fast enough to keep pace with inflation.

Interest-rate risk surfaces in a few ways, but typically revolves around how rates will change. Say Ben decides to go with a long-term certificate of deposit for what he considers his risk-free return; if he locks in a low payback and then rates go up, he could be stuck losing ground to inflation.

Shortfall risk is about you, personally, more than it is the market, but it's the chance that you won't have enough money to make your goals. You can face shortfall risk by being either too conservative or too aggressive. The best way to address this risk is to save more.

Timing risk is another highly personal factor, hinging on your personal time horizon. While experts agree that the chance that stocks will make money over the next two decades is high, the prospects for the next two years are murky, and if you need your money in two years, you should have concerns about your timing.

Liquidity risk comes in several forms and affects everything from junk bonds to foreign stocks. On a broad scale, it can be the chance that investments in a particular country suffer during some sort of credit crisis. For investors like Ben, looking for increased yield that feels safe, however, it can occur in high-yield products like nontraded REITs, where the investment is not liquid and cannot be sold at its perceived value if the money is needed on a moment's notice.

Political risk is the prospect that government decisions will impact the value of your investments. This covers everything from tax-rule changes—which can spur certain types of investing—to broad policies that might dampen a market's prospects.

Societal risk is ultra-big picture, looking at world events. This is what might happen in the event of terrorist attacks, war or catastrophe.

Beyond those broad categories, there's currency risk (highlighted by swings in exchange rates and how they hit certain securities), default or credit risk (the chance that borrowers might not pay their debts) and more.

But mostly, if you want to avoid problems with risk, you need to stop thinking that there's a class of investments that are risk-free. ■

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