Understanding Risk is the Key to Rebuilding Investment Portfolios prepared for Robert R. Tweed

It's a very rare investment portfolio that hasn't sustained losses from the recent market downturn in everything from stocks to real estate. The challenge now is to rebuild those portfolios. But to do so successfully, says financial adviser Robert Tweed, president of Tweed Financial Services, Inc. in San Marino, Calif., investors need to understand and manage risk.

"Prior to 2008, very few investors realized how vulnerable their investments were to losses," explained Tweed. "Solid, dividend paying stocks like GM and GE and financial institutions such as WAMU and Wachovia were supposed to be safe investments for widows and orphans. Nothing could happen bad enough to shake their foundations. The last two years have proved that wrong. Now the question is why? How could so many people have been so wrong?"

"There's a term in behavioral finance called anchoring," said Tweed. "With anchoring, investors often base expectations for the future on recent experience. Real estate prices had been on an upward trajectory for over 20 years, therefore they were expected to continue to increase. Because of that expectation, many home owners and lenders saw little risk in borrowing against 100% or more of the value of real estate."

Back in the 1950s, economist Hyman Minsky summarized the risk of this approach perfectly, said Tweed:

When times are good, investors take on risk; the longer times stay good, the more risk they take on, until they've taken on too much. Eventually, they reach a point where the cash generated by their assets no longer is sufficient to pay off the mountains of debt they took on to acquire them. Losses on such speculative assets prompt lenders to call in their loans. "This is likely to lead to a collapse of asset values," Mr. Minsky wrote.1

"The danger is that as the whole world re-evaluates risk, investors become too risk adverse." Investors, explained Tweed, face the risk of loss not only from market downturns, but also from inflation and taxes. They can't afford to "anchor" their behavior based on the financial market of the last two years.

"Fearing to lose money, individuals fail to invest and in the process lose ground to inflation and higher taxes. We see this as a bigger threat to retirement and financial security than investing in equities, real estate and other assets."

To help individuals rebuild their investment portfolios, Tweed offers the following advice:

1. Understand that every investment involves some measure of risk, i.e. the potential for loss. There is no such thing as a fail safe investment. Even holding cash exposes you to the risk of inflation eroding its value.

2. Recognize that the higher the potential return, the higher the risk. This isn't bad. Knowing the risks enables you to put in place a plan to control those risks.

3. You can't afford to invest and walk away. Investments need to be managed. Risk levels will change with time and markets.

4. Investments can go bad. Have a means of monitoring the performance of your investments and a plan in place to sell or terminate an investment if it turns against you or fails to perform as expected. This is where most investors fail. They don't have a plan to cut their losses early and move on.

5. Diversify. Invest across asset classes and income streams. Diversification is not investing in five different mutual funds. Diversification is investing in assets for growth, income and/or appreciation that respond to different geographic, industry and economic factors.

6. If you use a financial advisor, you don't owe that individual your trust. Have a means to independently verify the accuracy of any financial reports, what you own through your investment portfolio, and how that investment is performing. Investment managers need to be managed.

7. Be very careful of leverage. Overleveraging, incurring too much debt to the point where any loss of income could force you to sell assets at a loss, is one of the greatest risks investors face. Overleveraging is the root of the current global financial crisis.

"Rebuilding portfolios requires two actions," said Tweed. "One, you need to be saving aggressively. Two, you need to be investing wisely by understanding the risks inherent in an investment and having a plan to manage those risks. The one thing you can't afford to do is nothing."

Different types of investments involve varying degrees of risk and there can be no assurance that any specific investment will be profitable. Past performance may not be indicative of future results.

1 "In Time of Tumult, Obscure Economist Gains Currency: Mr. Minsky Long Argued Markets Were Crisis Prone; His 'Moment' Has Arrived," Justin Lahart, Wall Street Journal, August 18, 2007; Page A1.

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