WHITE OAKS
WEALTH ADVISORS, INC.

White Paper

The True Meaning of Risk

As the stock market has lurched up and down this past year making everyone queasy, it is important to understand ones decision-making when it comes to risk. Risk is not merely the fluctuation in value you are prepared to accept in a portfolio. It is also one of the key factors that means the difference between increasing, or more importantly, ***reducing*** *the probability of achieving your financial goals.*

Written by

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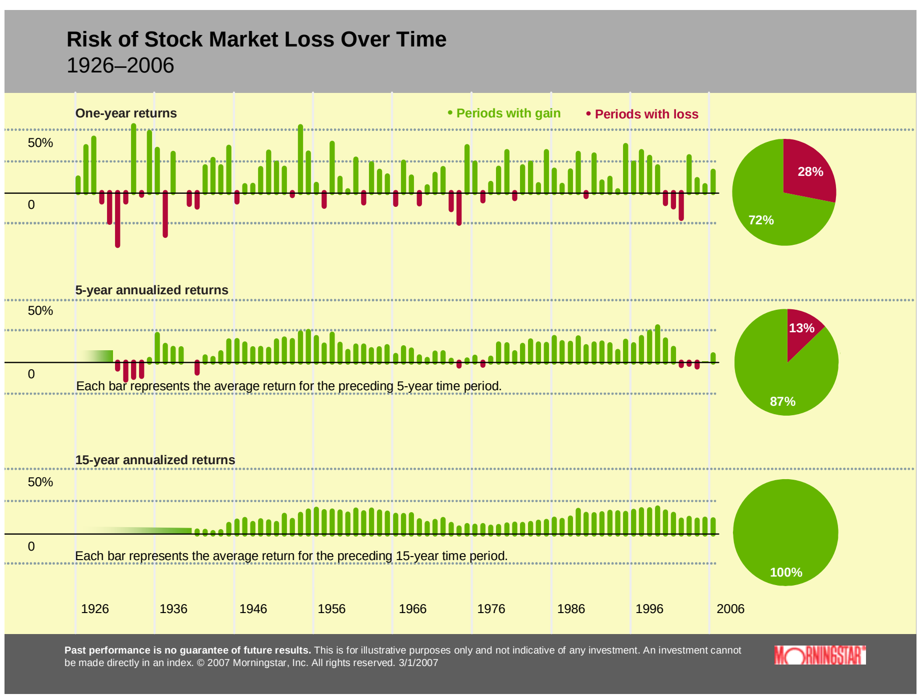
One of the most frequent questions we get as advisors is "should my portfolio be more conservative?" This question comes up especially when clients near retirement, or when market volatility increases and leaves people a little more uncertain about the imminent future direction of the market. To address the question of whether and when you should be more conservative (and therefore reduce the volatility (risk) in the portfolio) we are going to walk through some of the decisions and information that one needs to mull over.

Reduction of risk over time:
Are you a conservative or an aggressive investor? Those terms mean different things to different people. Our clients fill in a questionnaire that asks the same question three different ways to come up with a more informed and less (being the operative word) subjective answer. To some, an aggressive investor is to put it "all on red", to others aggressive means an all-equity, fully diversified, portfolio over multiple asset classes. One of the keys in looking at risk (volatility) is to look at the reduction over time. Table 1 below shows the US stock market returns between 1926 and 2006. If you look at this time period by one year timeframes - 72% of the time you have a gain in your portfolio and 28% of the time you had a loss. If you lump the timeframes in to 5 year periods – so the annualized return during 1926-1930, 1927-1931 etc you find that 87% of the time you have a gain and 13% of the time you have a loss. If you lump the timeframes in to 15 year periods you can see that 100% of the time the annualized return is a positive return. So what does that tell us? That tells us that your risk of stock market loss reduces over time.

Table 1



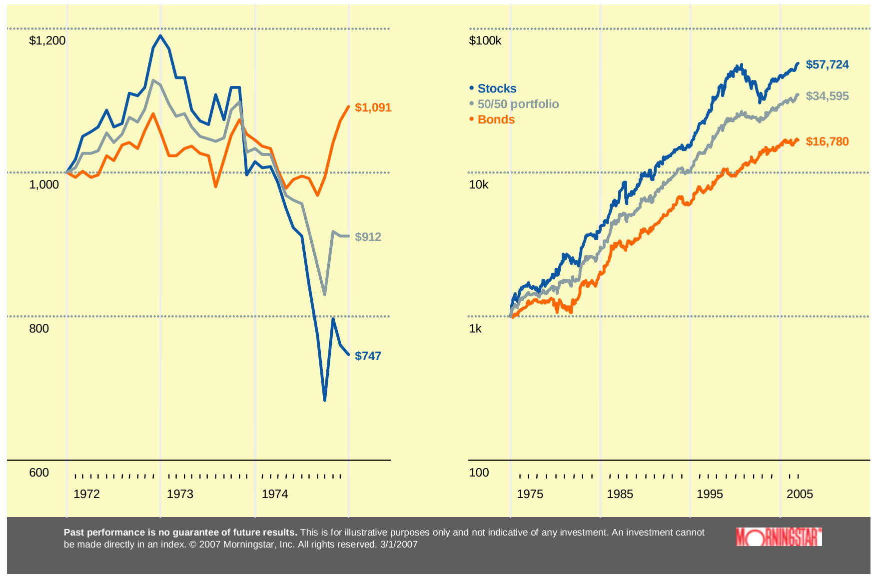
The ability of live with risk:
The point above (reduction of risk over time) is meaningless if you cannot stay the course for the time period. People are emotional beings and when the market goes down people start to flee out of stocks. Does the volatility (amount the portfolio increases and decreases by value) cause you to lose sleep? Are you likely to pull out of the market and in to cash in a market crash? The challenge is that when the market is in recovery – about the time you feel comfortable to go back in to the stock market, the run up has most probably already happened. Finding a level of volatility you can live with in a down market is very important in being able to stay the course. Can you only live with an average of 5-10% down in a given year before firing your advisor and going to cash, or could you live with an average of 20-30% down in a given year without losing sleep?

Table 2 shows an example of the importance of staying the course. If you take the dark blue line, a 100% stock portfolio - If you invested $1,000 in 1972 it was worth $747 at the end of 1974. Losing that much money would make many people adjust their portfolio. But the graph to the right shows that $1,000 invested in 1975 ends up being worth $67,724 by the end of 2005. If that same investor had been frightened by the losses in the early 1970s had instead moved to a 100% bond portfolio – the end result of a $1,000 in 1975 would be $16,780 at the end of 2005 – a significant difference. Think of the impact of that difference in value of a portfolio in being able to support lifestyle and financial goals?

Being more conservative with age?
Should you reduce the volatility of your portfolio with age? The key is (1) how much volatility can you live with without changing course? (2) can you accomplish your income needs in retirement with a reduced return (taking in to account the eroding impact of inflation and unknowns such as higher taxes, health care costs, etc.)? and (3) do

Table 2

Can You Stay on Track?



you have excess money that you fully expect to outlive your assets and at this point are really wealth building for the next generation (this will be tackled in the next section)?

Old habits die hard. When our grandparents retired – they were expected to die shortly after retirement and many had pensions that guaranteed income. Retirement to the baby boomer generation and beyond nowadays means a 30-40 year retirement period mostly funded by IRA, 401k and savings rather than pensions. Modern retirement needs clearly need a different approach to the bond portfolio your grandfather held. If you can live with a 15% downside in a given year without adjusting the course then why pretty much guarantee yourself a lower return and reduced FLEXIBILITY? Some people don't have the luxury of being more conservative. They simply do not have the ability to expect a lower return if they still want to maintain their lifestyle. This is the true meaning of risk! Will reducing the portfolio return mean not being able to accomplish your financial goals?

Leaving money for your heirs.
Are you taking so little income from your portfolio that the high likelihood is that it will be passed to your heirs? Say I'm 80, and I am living on $100,000 a year and have a $5 million portfolio. Why would I want to be in a conservative portfolio? My money will go to either charity or my heirs? If I lived another 15 years before passing on – my heirs would potentially get significantly more money being invested in a more aggressive portfolio than sitting in bonds? Suitability as to how your portfolio is structured is based on your risk tolerance and your ability to have some flexibility. If you are 80 with very little money left, and your portfolio is being used up quickly, and cannot withstand your withdrawals in a down market, then you don't have the luxury of dialing up the volatility. But if you are living on less than a roughly 4% distribution from your portfolio you can design your portfolio for increased growth for the next generation.

Summary: Not achieving goals.
Risk is so much more complex than just the measure of volatility in the portfolio. Not only asking your advisor about the potential downside of a portfolio allocation, but also asking them if you have a good likelihood of achieving your goals based on your current projections is equally important. You don't have to adjust your portfolio – you can choose to work longer, live on less or save more to still accomplish your goals. But having more insight in to your ability to "stay the course" , to understand the reduction of risk over time, and to be more specific about your downside risk tolerance in helping your advisor find an appropriate portfolio allocation for you, will vastly increase your comfort and understanding of risk and potentially mean the difference in achieving your goals.

For further information, contact Sharon A. Bloodworth at 800-596-3579, or visit www.whiteoakswealth.com
The advice in this article is meant for informational purposes only. It is important to seek personal advice from your financial professional as everyone's situation is different.