# Wealth Creation

## . . . and Preservation

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# What does it cost to avoid RISK?

**Editor's Note:** As I worked on my first book *Moneywise* I came to the point where I needed to define the cost of sharing or eliminating risk. Let me try to quickly explain what I mean by that, for it is not a topic you are likely to read about anywhere else. Not all of this material was incorporated into *Moneywise*.

All investments carry a degree of risk. In *Wealth Creation and Preservation* I have talked at length over the years about how **the potential for loss of principal is a characteristic of all investments**. If we are going to put our hard-earned money at risk, we want to achieve a meaningful return on our investments while assuming an appropriate amount of risk.

Here is a "spectrum" of risks sequenced from the greatest risk to the smallest risk, all other things being equal. Most of my readers will be unfamiliar with at least some of the investments described below.

① Fully-leveraged commodities futures. In these investments you may be borrowing more than 90% of the amount you are purchasing. A "leveraged" investment of that type can go against you 10 times as fast as an unleveraged investment.

② Fully leveraged "naked" commodity options. For example, selling a Silver $15 call option could provide you with a maximum gain of about $1,000, but your risk would be unlimited. If Silver went to $100 an ounce, you would lose $425,000.

③ Fully leveraged residential real estate. If you were to borrow, as you can today, 103% of your purchase price, if housing prices fell in your neighborhood for any reason you could lose your home very quickly. At this time you can still obtain 100% financing on a negative amortization loan, which means that your loan amount increases month after month after month. In my quarter-century in this business I have seen few better ways to commit "financial suicide." In fact, this problem is becoming so severe that Congress is debating ways in which you will get to bail out those foolish enough to take on these mortgages. Stay tuned.

④ Stocks described as " speculative", "small-cap", "pink sheet", "emerging market", and so on. Many of these can be purchased using margin, which means that you are borrowing up to half the purchase price. That, of course, can double your risk.

⑤ Stock mutual funds, Exchange-traded funds (ETFs), and large-cap stocks for which you have paid the full purchase price.

⑥ "Junk" bonds purchased individually.

⑦ "Long" call and put options.

⑧ Government-guaranteed bonds, such as US Treasury Bonds, as well as "junk" bond mutual funds and ETFs.

⑨ Fixed annuities, Equity Index Annuities, and Certificates of Deposit.

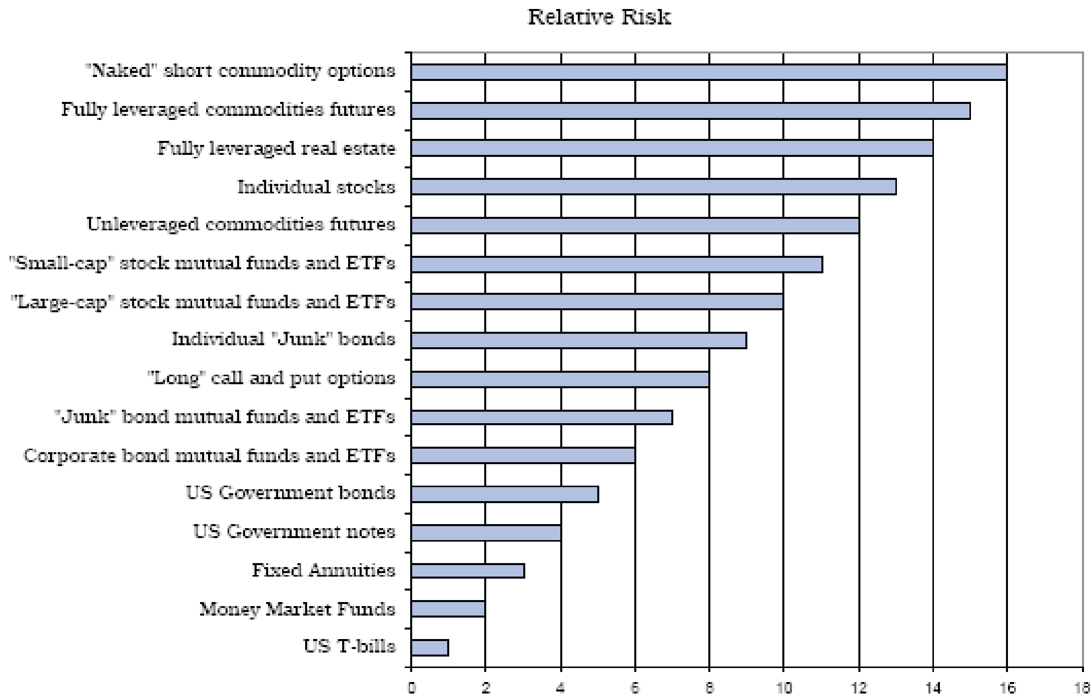
⑩ Money market funds.

This is not a comprehensive list by any means, and we could debate the placement of each of the items on the list relative to the others. This is just a ranking by risk level of some of the better-known investments available today. Let's consider for a moment the relative risks associated with each of these before we move on. I have discussed each of them in previous issues of *Wealth Creation and Preservation*.

When you buy a fully-leveraged futures contract for corn you are paying for only about 5% of your purchase. If corn is

currently selling for $3.95 a bushel, you are buying 5000 bushels for a total cost of $19,750. You can do so by meeting the margin requirement of $540. All that corn has to do is to fall $.11 ($.11 times 5000 bushels equals $550) and you have lost 100% of your investment. In order to "manage" your risk, you need to be familiar with the seasonality of the agricultural markets, the prospects for the crop you are buying, and the timing of your purchase.

Fully leveraged "naked" commodity options are commonly used by hedge funds, among others. Like leveraged commodities futures, they offer the potential for unlimited risk. In order to manage your risk you need to consider all of the fundamentals pertaining to the particular commodity. You also need to have superb timing.




The bars illustrate the risk of each investment type relative to the others. There is no exact scale of comparison, which is why this chartis entitled *Relative* Risk.

Investing in residential real estate hasn't required an awful lot of skill until just a couple of years ago. Many of the new millionaires in the United States have gained that status through real estate speculation. Millions of others have profited from selling their home after decades of price appreciation. Only recently have significant risks entered into the market, in part because of foolish and risky governmental policies regarding housing availability and interest rates.

Speculative stocks are just that; speculative. Some of them are not available on "margin", which means that you cannot

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borrow a portion of the purchase price. That doesn't make them any less risky; it just means that you're not going to be allowed to make twice as big a mistake when you buy them.

Managing risk requires strong fundamental and technical analysis. Contrary to the current advice available almost everywhere, I strongly recommend that you "buy low and sell high".

Mutual funds of any type, along with all the ETFs, offer a risk-reducing feature we haven't seen before in this list; **diversification**. When you purchase a mutual fund or an ETF you are buying a share of a managed pool of stocks, bonds, or some combination of securities or commodities. Your risk is reduced because you aren't buying one single item. Even so, you can manage your risk by performing appropriate technical and fundamental analysis on the fund or its sector.

You probably are familiar with the rest of the choices on this list. The most important point that I'm making here is that with few exceptions **as the risk declines so does the potential for gain**. At this moment Money Market funds, which have very little perceived risk are paying yields comparable or even superior to those offered by Certificates of Deposit and fixed annuities. I'm not talking about the money market account your bank or credit union offers; I'm talking about a money market fund offered by a family of mutual funds like Fidelity or American Century.

The reason why I do so much work with Equity Index annuities (EIAs) is that in some ways they are an exception to the rule. EIAs (and Total Return Fixed annuities or TRFAs) are completely guaranteed as to principal and interest. They are specifically designed to enable you to make more money than you might in a standard fixed annuity. To provide that safety of principle that is not available from any stock or mutual fund, the trade-off is that you have to give up some of the potential for gain. That trade-off appears in your annuity as a "cap" or in the averaging method used to compute your gain.

Here's the point: **avoiding risk has a price**. That price is usually represented by decreased potential for gain. The intelligent management of risk requires more decisions today than ever before, due to the much wider variety of financial products and services available.

There has never been a greater need for competent, analytical, professional financial advisors. Unfortunately, they remain few in number and very hard to find. It is not enough for your financial advisor to be familiar with all the different financial vehicles and products available to you. It is not even enough for him to do that and have the ability to guide you in your decision-making process. He is also required to have his "ear to the ground", listening to the markets and being able to anticipate where they're going if he is to be of benefit to you. Finally, he also needs to have the freedom to implement those financial choices which are most appropriate for you. I try to do and to be all of those things, but the task becomes more difficult every single day.