January 2017

LORING WARD

Portfolio Perspectives

Monthly Insights for Investors

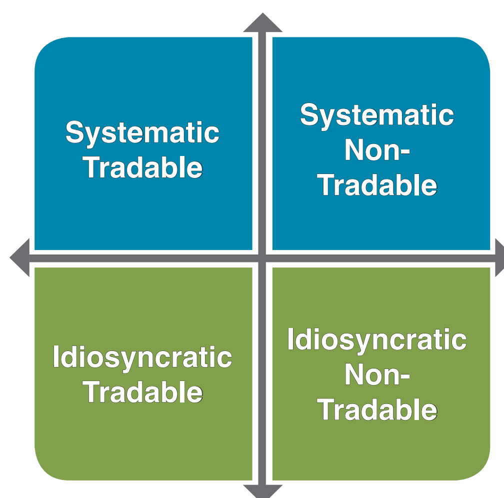
Financial Risk through a Wide-Angle Lens

by **John T. Scruggs, Ph.D.,** Vice President of Research, Loring Ward

The world is risky. The future is uncertain. And many of the decisions we make can have a profound impact on our future welfare. This is where financial advisors can add value by helping their clients navigate an inherently risky world. Risk cannot be eliminated, but it can be managed.

Financial risk can be defined any number of ways, but fundamentally it is uncertainty about future cash flows and asset values. This is why we have to consider risk beyond the traditional portfolio of stocks and bonds, and factor in other important assets such as human capital and real estate.

In broad terms, we divide risks along two dimensions: systematic vs. idiosyncratic and tradable vs. non-tradable. Using these two dimensions, we can classify asset risks into four categories that make up the taxonomy of risk.



The distinctive feature of a systematic risk is that it affects a large number of assets and cannot be diversified away by holding it in a portfolio. For example, most stocks can be exposed to overall economic risk. Stock prices tend to rise in response to good news about the economy and decline when the news is bad. Credit ratings and prices for corporate bonds tend to be higher when economic growth is strong. And many people earn higher incomes when the economy is strong.

In contrast, an idiosyncratic risk affects a small number of assets and can be diversified away by holding a portfolio of many stocks (as long as no single stock holding is too large). For example, a pharmaceutical company may discover a new drug, providing good news for that one company's stock. On the other hand, a fire at an oil refinery may affect another company's stock negatively. Good news for one asset can be offset by bad news for another asset.

The second dimension of risk relates to whether the asset is tradable. The ownership of a public company is divided into many small shares that trade on a stock exchange, meaning a company's risks can be shared by many shareholders. An investor who holds the stock indirectly through a mutual fund can bear the systematic risk and diversifies away the idiosyncratic risk.

Investment advisory services provided by LWI Financial Inc. ("Loring Ward"). Securities transactions offered through its affiliate, Loring Ward Securities Inc., member FINRA/SIPC. R 17-006

The story is much different if the company is a family business. In that case, the asset is non-tradable and it represents a substantial share of the family's wealth. The family must bear both the systematic and idiosyncratic components of risk. Tradability enables risk sharing.

Now that we've covered the basics, let's examine a few important asset classes.

Common Stock. Common stocks are tradable and exposed to both systematic and idiosyncratic risks. Since systematic risk cannot be diversified, the market demands a premium for bearing it. The higher the systematic risk, the higher the expected return. Idiosyncratic risk, on the other hand, can be virtually eliminated by simply holding stocks in diversified mutual funds. Financial markets do not reward idiosyncratic risk because it can be eliminated at very low cost. This is why most financial advisors typically don't recommend large positions in individual stocks. Why bear uncompensated risk?

Human Capital. For many individuals, human capital (future lifetime income) is their most valuable asset. Human capital is not tradable (you can't sell shares in yourself), so the individual is fully exposed to both systematic and idiosyncratic risks. For example, a realtor's income can be highly variable and is correlated with the health of the real estate market. His human capital is more stock-like. On the other hand, a tenured professor's income is very predictable. Her human capital is more bond-like. The realtor might choose to hold more bonds in his portfolio, and the professor might choose to hold more stocks in hers. Financial advisors can provide valuable guidance in choosing the most appropriate portfolio.

The idiosyncratic risks to human capital — unemployment, disability and mortality risk — threaten an individual's income-producing ability. Fortunately, there is a way to protect against the financial impact of each of these risks: insurance. Insurance policies are contingent claims that pay off in the event of loss, injury or death. From the household's perspective, human capital is less risky when the individual is insured. Financial advisors can assist with making decisions about insurance.

Pensions and Social Security. Pensions are valuable assets. Because a pension is a claim to future fixed cash flows, it is a close substitute for bonds. Inflation-indexed pensions, such as Social Security, are uniquely capable of hedging inflation risk in future consumption. As long as a pension fund is financially secure, a pension is an asset that is relatively free of systematic risk. Thus, someone with substantial future pension income might be well-suited to take more stock risk in their traditional portfolio. However, the income paid by a pension is exposed to the mortality risk of the pensioner and, perhaps, the pensioner's spouse. Mortality risk is an idiosyncratic risk. Financial advisors can provide valuable advice on how pensions and Social Security fit into an overall financial plan.

Real Estate. An owner-occupied home is a special asset that provides many valuable services to its owners. Its value can be estimated by observing market rents for similar homes. (Zillow is a great resource for estimating the rent one would have to pay if one didn't own a home.) Owning a home hedges the owner against inflation risk in future housing expenses. Home values and rents in a region tend to move together, so real estate is exposed to a systematic risk. Real estate is also subject to idiosyncratic risks such as fire, flood and earthquake. These risks can be limited with appropriate insurance policies.

Everyone has unique goals, assets, and risk exposures. An experienced financial advisor uses a holistic "wide-angle lens" to learn what makes each client unique, and then tailors a plan to manage financial risks and help clients achieve their most important long-term goals.