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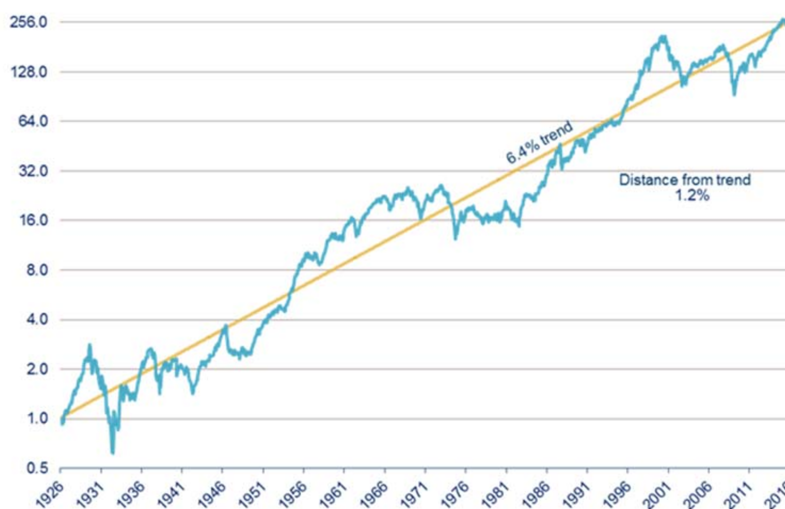
How Much Risk Should You Take?

In a letter regarding the potential permanency of the new US constitution, Benjamin Franklin famously said that "in this world nothing can be said to be certain, except death and taxes." As investors, we deal with the reality of uncertainty every day and have to decide how much we want to expose our portfolios to these uncertainties. Equally however, one of the realities we face today is that, with interest rates so low, traditionally "safer" investments like cash and Government bonds carry the risk that their returns do not keep pace with inflation. We call this purchasing power risk, and over longer term horizons it is the reason many investors including major pension funds and endowments chose to accept the uncertainty of investing in more volatile investments such as stocks. In our opinion, investors who focus on a timeframe of five years or more can reduce the risk of losing money in stocks, potentially allowing them to participate in the possibility of higher returns.

Defining risk as the "probability of losing money over a given timeframe." Our industry often measures risk in terms of volatility, using the standard deviation of annual returns to measure such volatility. For many investors, this approach is not helpful as they don't have an intuitive understanding of what this metric means. We believe it is easier to understand risk as the potential to lose money, but we further believe that it is helpful to quantify risk of loss over a given timeframe. History shows that the risk of losing money in stocks has reduced dramatically with time; i.e., there are more one-year periods where stocks have fallen than 5-year periods. *Past performance is no guarantee of future results.* We also believe the risk of losing money varies depending on the entry point, and therefore, that the price you pay matters. We illustrate this with the charts below, the first of which shows the history of Large Cap US stock returns, net of inflation, since 1926. As of September 30th, the index is very close to its long-term trend (the gold line) which has risen at 6.4%.

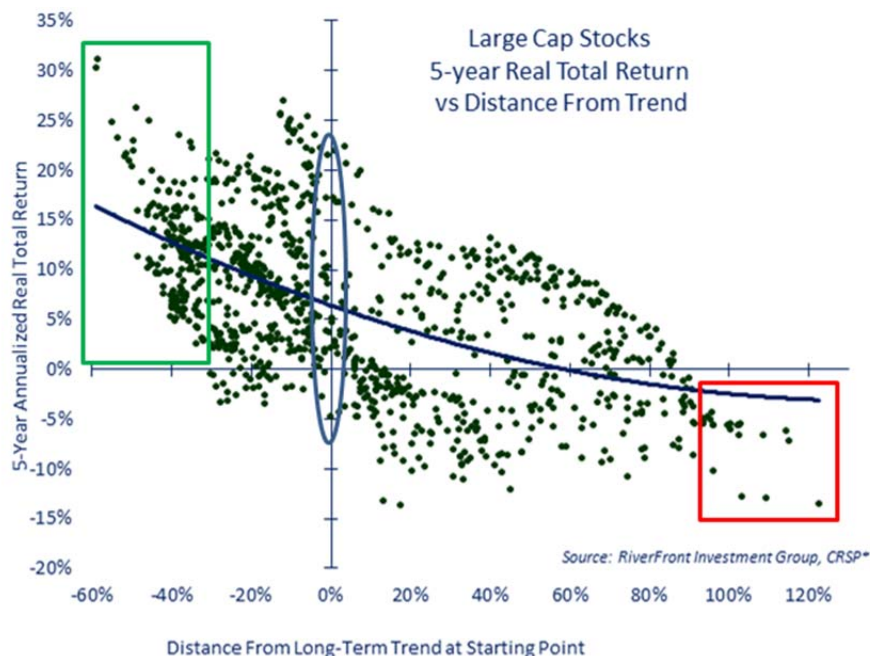


Source: RiverFront Investment Group, calculated based on data from CRSP 1925 US Indices Database ©2016 Center for Research in Security Prices (CRSP®), Booth School of Business, The University of Chicago. Data from Jan 1926 through Sep 2016. Past performance is no guarantee of future results. It is not possible to invest directly in an index. Information is provided for illustrative purposes only and not intended as an investment recommendation.*

We interpret our calculations to mean that the risk of losing money in a 5-year holding period increases as stocks get further above the long-term trend. We illustrate this in the chart below, in which each dot represents a monthly starting point from the data in the chart on page one. For each monthly observation since 1926 we ask two questions: What is the distance from trend at the

starting month, and what is the subsequent 5-year real total return? We plot the distance from trend on the horizontal axis. The vertical line is set at a zero or "on trend", and to the right of the vertical line are observations where the starting point gets further above trend (overvalued). To the left of the vertical line are those periods which are below trend (undervalued). When the starting point has been more than 90% above trend (the red box), you will see that all subsequent 5-year periods have been negative – there are relatively few observations, most of which occurred in 1929 and 1999. Equally, when the starting point has been more than 31% below trend (the green box), all subsequent 5-year periods have been positive, and even more positive when the starting point has been more than 40% below trend as it was briefly in early 2009. This analysis has been very helpful in assessing the risk and reward at market extremes. *While the above analysis is based on historical data, past performance is no guarantee of future results and there can be no assurances that movements or trends can or will be duplicated in the future.*

THE WEEKLY CHART: MEASURING RISK IS EASIER AT EXTREMES



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As of September 30th 2016, the index is a mere 1.2% above trend, and thus very close to the vertical line. The blue oval shows the positive and negative 5-year returns when the starting point is close to the trend. There are a lot more positive outcomes when stocks start around trend and the negative outcomes relate mainly to the 5-year periods from early 1974 to 1979 when inflation accelerated dramatically. The range of returns is very wide (from minus 5% per year to plus 23%) making risk management less clear cut. Our balanced solution which has a benchmark of 50% S&P 500 and 50% Barclays US Aggregate Bond Index seeks to generate positive inflation-adjusted returns at a 5-7 year time horizon, even during extremely adverse environments. To achieve that objective, we currently have 55% stocks split 43% US and 12% overseas, to which we add 17% high yield bonds and 27% investment grade bonds/cash. Our portfolios targeted to timeframes of seven years or more, currently have over 80% in stocks and a higher relative allocation to non US stocks. This positioning reflects our belief that risk and timeframe are closely aligned.

Important Disclosure Information:

Past performance is no guarantee of future results.

** Market Cap index information calculated based on data from CRSP 1925 US Indices Database ©2016 Center for Research in Security Prices (CRSP®), Booth School of Business, The University of Chicago.*

Used as a source for cap-based portfolio research appearing in publications, and by practitioners for benchmarking, the CRSP Cap-Based Portfolio Indices Product data tracks micro, small, mid- and large-cap stocks on monthly and quarterly frequencies. This product is used to track and analyze performance differentials between size-relative portfolios.

CRSP ranks all NYSE companies by market capitalization and divides them into ten equally populated portfolios. Alternext and NASDAQ stocks are then placed into the deciles determined by the NYSE breakpoints, based on market capitalization. The series of 10 indices are identified as CRSP 1 through CRSP 10, where CRSP 10 has the largest population and smallest market-capitalization. CRSP portfolios 1-2 represent large cap stocks, portfolios 3-5 represent mid-caps and portfolios 6-10 represent small caps.

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ETFs are subject to substantially the same risks as those associated with the direct ownership of the underlying securities owned by the ETF. Additionally, the value of the investment will fluctuate in response to the performance of the underlying index or securities. ETFs typically charge and/or incur fees in addition to those fees charged by RiverFront. Therefore, investments in ETFs will result in the layering of expenses.

Investments in international and emerging markets securities include exposure to risks such as currency fluctuations, foreign taxes and regulations, and the potential for illiquid markets and political instability.

Stocks represent partial ownership of a corporation. If the corporation does well, its value increases, and investors share in the appreciation. However, if it goes bankrupt, or performs poorly, investors can lose their entire initial investment (i.e., the stock price can go to zero). Bonds represent a loan made by an investor to a corporation or government. As such, the investor gets a guaranteed interest rate for a specific period of time and expects to get their original investment back at the end of that time period, along with the interest earned. Investment risk is repayment of the principal (amount invested). In the event of a bankruptcy or other corporate disruption, bonds are senior to stocks. Investors should be aware of these differences prior to investing.

Strategies seeking higher returns generally have a greater allocation to equities. These strategies also carry higher risks and are subject to a greater degree of market volatility.

High-yield securities (including junk bonds) are subject to greater risk of loss of principal and interest, including default risk, than higher-rated securities.

Technical analysis is based on the study of historical price movements and past trend patterns. There are no assurances that movements or trends can or will be duplicated in the future.

In a rising interest rate environment, the value of fixed-income securities generally declines.

RiverFront's Price Matters® discipline compares inflation-adjusted current prices relative to their long-term trend to help identify extremes in valuation.

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Index Definitions:

It is not possible to invest directly in an index.

Standard & Poor's 500 Index *(S&P 500) measures the performance of 500 large cap stocks, which together represent about 75% of the total US equities market.*

Barclays US Aggregate Bond Index *(Barclays Agg) is an unmanaged index that covers the investment grade fixed rate bond market with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. The issues must be rated investment grade, be publicly traded, and meet certain maturity and issue size requirements.*

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