

THIS WAY FORWARD

YOUR WEALTH



“Getting Real” About Portfolio Behavior

>>>Learn the difference between volatility and risk. *By Ken Kamen*

Having sustained the pain of the recent tumultuous market climate on Wall Street, many investors feel particularly unnerved by the prospect of having to make new decisions that will affect their financial futures in an uncertain world. Their apprehension is appropriate and, in fact, prudent. The real threat to their financial future is that anxiety can quickly turn into panic and panic can result in rash decision-making. But you can prevent this if you truly understand the nature of risk and how much you are really taking.

To “get real” about risk, the best place to start is by understanding the difference between risk and volatility. Risk can be defined as the chance that you won’t reach a desired outcome. Volatility describes how bumpy the path to that outcome will be. The more uncertain the outcome, the more volatility will be associated with it. So there are two factors to consider: your willingness to take risk and your tolerance for volatility.

Start by getting a handle on your true cost of living. Give serious thought to the role your investments

need to play in both the short and long term. If your short-term needs can be met only by selling assets that were purchased to achieve your long-term goals, and if you end up forced into an ill-timed sale that nets you a lousy price, it’s not risk but volatility that’s undermining your plans. Avoid that scenario by making a realistic determination of the amount you need in the event that unexpected expenses oblige you to supplement your primary sources of income, and then put a cash reserve aside.

Next, analyze the risk level of your portfolio. Is it designed to swing for the fences with companies that have little or no track record, or is it invested in companies with a proven manage-

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ment team and a long history of solid growth? While the potential upside of owning a new company that has breakout success is great, equally great is the risk that its potential will never be realized. The way to manage risk is by diversifying your portfolio among investments that have low and high levels of predictability. Bear in mind, though, that high predictability is not always the same as low volatility. Even the stock prices of strong, financially stable companies with long histories of good management and predictable cash flows go through volatile periods. The danger to your financial future is selling these fundamentally sound companies at fire sale prices because you confused volatility with risk.

Then assess what you can truly afford to risk. An older person who needs a three-bedroom house doesn’t have to build a home with eight bedrooms, and the same concept applies to finances. Why construct a portfolio overweighed in high-risk investments with low predictability to chase a 15 percent annual return if your needs can be met with a lower-risk, more predictable portfolio that produces 5 percent? You’ll experience volatility in both cases, but you’ll sleep better if you’re more confident about achieving your hoped-for results.

When all is said and done, how the broad market is behaving is less important than whether your own portfolio is on course to meet your personal goals and expectations. **NJB**

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