

Compliments of  
Donald G Creech, CFP(r) AIF(r)  
Investor Resources, Inc.

**QAIB 2005**  
**Advisor Edition**

**How Risky Is It anyway**

***Extract of Quantitative Analysis of Investor Behavior***  
***"2005 "***

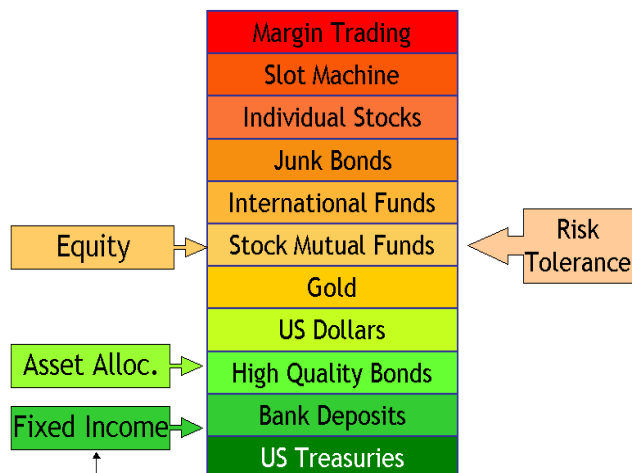
The DALBAR Risk table relates investment risk to other familiar forms of risk to allow investors to make informed decisions about the level of risk that can be tolerated.

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## Communicating Risk



*Illustrates how a specific investment can be depicted on the Risk Table.*

### Application of Risk Table

The DALBAR Risk Table is based on principles of behavioral finance and is designed to educate and not manipulate investors aversion to risk. The understanding of risk then causes more rational behavior.

A common practice has been to assess the aversion to risk and react to the aversion, whether it is in the investors' best interest or not. An alternative practice is to wait for a change in investors' aversion to risk.

The Risk Table provides a critical anchor for investors to understand risk in relation to a variety of familiar concepts. This anchoring process puts exposure to loss in a context that reduces the irrational fear of risk.

The behavior based Risk Table uses the history of loss as the basis for ranking each item. This historical perspective gives weight to both the frequency of loss and the magnitude of the loss.

### Risk: Root Cause of Bad Behavior

Behavioral finance, as well as personal experience has established that no other factor influences investor behavior more than the aversion to loss (risk). There is also general agreement that a good understanding of risk produces more prudent behavior.

The Guess Right Ratio section of the QAIB report shows that most investor mistakes are made in attempting to avoid loss. In the 20 year analysis investors were found to correctly guess the direction of the market over 75% during rising markets but less than 50% during falling markets.

The actions driven by aversion to loss are the primary causes of losses among mutual fund investors.

### Commentary

Whether it is stated or goes unsaid, concern about risk exists in every investor's mind and is a significant influence of behavior. The imprudent response to risk is very often based on the fear of catastrophic loss.

Concern about risk is greatest when:

- 1) an investment decision is required,
- 2) after a loss and
- 3) after news of loss by others.

These events present the best opportunities for risk education. Risk education must first correct the fear of catastrophic loss by providing anchors to establish risk as being relative and then include explanations of how risk is controlled.

**"The biggest risk is getting out before the upturn."**

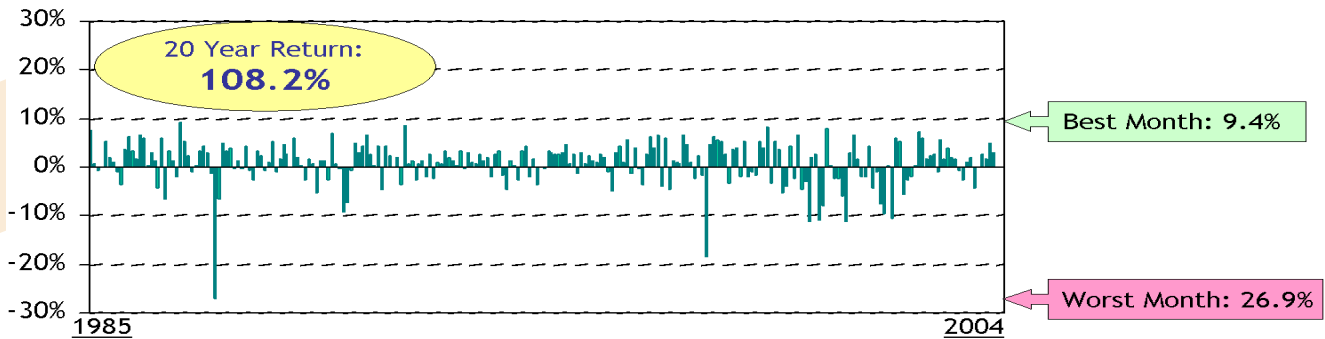


# Monthly Risk/Return Comparisons

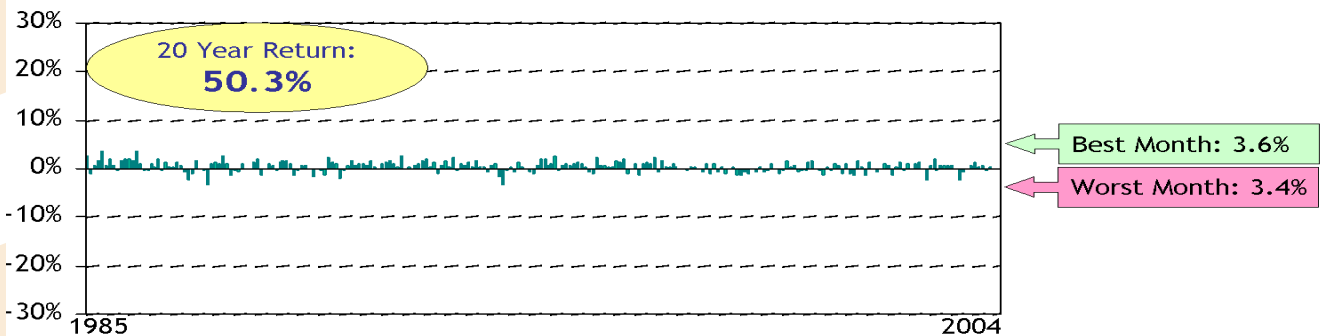
## History Sets Expectations

The accompanying charts show the best and worst case surprise that an investor experienced over the last 20 years. Charts depict the return the average investor would see on a monthly statement in the best of times and in the worst of times, between 1985 and 2004.

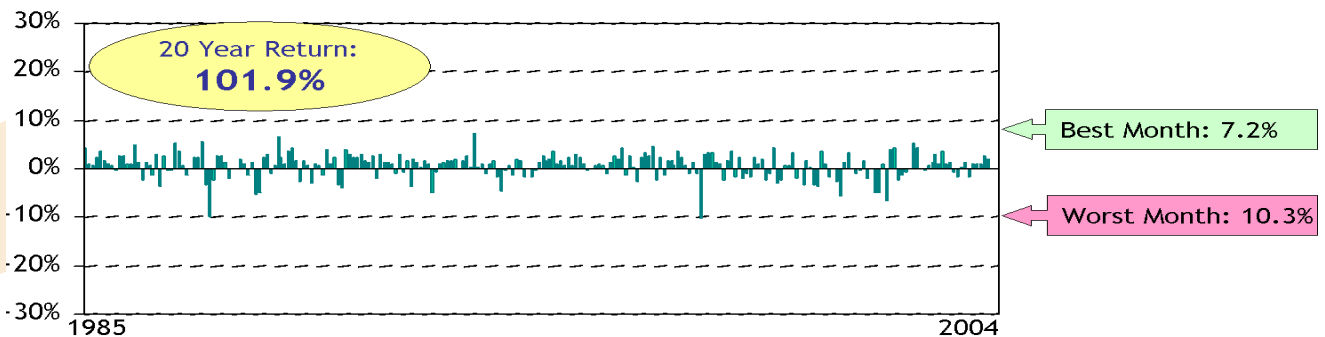
### Equity Fund Investors



### Fixed Income Investors



### Asset Allocation Investors





## Rational Risk

### What Makes Them Risky

The rationale for assigning the level of risk to each standard in the DALBAR Risk Table is presented in this section. The discussion also includes general references to some advantages of taking the risk associated with the standard. It should be noted that each standard is subject to changes in value over time.

#### US Treasuries

#### US Treasuries

US treasury securities are assigned the lowest level of risk because they are secured by the full faith and credit of the United States Government, which represents the strongest economy in the world.

The United States Treasury will pay the full amount of the investment plus the stated interest on the date specified for the US Treasury security.

#### Bank Deposits

#### Bank Deposits

Deposits, while also being very low risk, are riskier than US Treasuries for three reasons.

The first reason is that the only total guarantee is from the institution that holds the deposits. While highly unlikely, these institutions can fail. If the institution does fail, there is FDIC insurance that provides additional protection.

The second reason for the higher risk is that the deposit insurance is limited to the FDIC fund, which is created from fees paid by the deposit institutions. This fund can be depleted, as was the case with Savings and Loan insurance (SLIC) in the 1980's. This risk of insurance fund failure is reduced because of the expectation that Congress will make up any short fall as it did for the Savings and Loan industry. There is, however, no guarantee of this.

The third area of risk for bank deposits is the limit of \$100,000 of the FDIC guarantee. Should the institution fail, only the first \$100,000 of deposits is covered by insurance. Deposit balances in excess of \$100,000 may be lost.

Banks will pay the principal and interest of deposits on demand or on the date of maturity in the case of time deposits.



## Rational Risk - 2

### High Quality Bonds

#### High Quality Bonds

High quality bonds have the guarantee of the most creditworthy companies. These bonds are considered more risky than bank deposits because they have no separate insurance fund to guarantee payment if the corporation fails.

While it is very unlikely that a high quality bond will fail, it is possible for the quality of the bond to decline over time if conditions change for the company that issued the bond.

Companies will pay the principal and interest on bonds when they mature or at an earlier date, if the company chooses to "call" the bond.

### US Dollars

#### US Dollars

Unlike US Treasuries the dollar is not backed by the full faith and credit of the United States Government. Instead its value is determined by supply and demand in the international currency market. Fluctuation in the value of the dollar is reflected in the price of imported components of goods and services.

Over the long term the value of the dollar declines as the cost of living increases. One dollar today does not purchase as much as a dollar did ten years ago. Since the dollar earns no interest, the buying power always declines.

### Gold

#### Gold

While considered a precious metal, gold is in fact a commodity, the value of which depends entirely on supply and demand. Gold supplies are fairly stable (we have not had major new gold strikes for nearly one hundred years) so the changes in value are primarily caused by changes in demand. Since gold pays no interest or dividends, its value is unaffected by earnings.

The risk of owning gold is created by the interest (or lack of interest) by people in owning it. The greater the interest is, the greater the value.

Gold is considered more risky than US Dollars since its value has fluctuated more than the dollar. This higher risk should be considered in light of the fact that the value of gold has increased over time while the value of the dollar has declined.



## Rational Risk - 3

### Stock Mutual Funds

#### Stock Mutual Funds

Mutual funds reduce risk by diversification, a technique that uses a variety of different investments to reduce the effect of any one failing to perform. In this way, the risk of loss is reduced, while retaining the opportunity for growth in investments. Through diversification, mutual funds dramatically reduce the risk of investing.

Mutual funds also reduce risk by paying investors the income earned (dividends) and profits made (capital gains). These dividends and capital gains reduce the risk since investors continue to take their profits during the time they own the fund. It should be noted that this risk reduction only applies when dividends and capital gains are taken in cash and not reinvested back into the fund.

While stock mutual funds are available from high risk to low risk versions, the typical fund is only somewhat more risky than gold. Unlike mutual funds, gold does not pay dividends or distribute profits periodically.

### International Funds

#### International Funds

International funds also hold a variety of investments in order to reduce risk. The risk limiting processes used are identical to those described for Stock Mutual Funds.

International mutual funds are considered a higher risk because they make investments in foreign countries, where the investments are somewhat dependent on the less robust economies.

### Junk Bonds

#### Junk Bonds

These investments are somewhat more likely to fail, but do have the potential to pay very high interest if they don't fail. In fact, only about 4% have failed historically. Junk bonds are often packaged together and offered as a mutual fund to reduce risks. In this case, several junk bonds are put into one portfolio, with the expectation that the profits from successful ones will more than offset the loss from those that default.

Issuers pay junk bondholders principal and interest when the bond matures.



## Rational Risk - 4

### Individual Stocks

#### Individual Stocks

Individual stocks are vulnerable to the failure of one company. Should a failure occur, the stockholder receives any value that remains after all employees, creditors and bondholders are paid. This puts the investor in individual stocks at greater risk than all bondholders, including the junk bondholders.

Additionally, since there is no maturity for stocks, the risk is not evaluated over any specific time frame. Since virtually all corporations eventually dissolve, the risk is the method of dissolution. Some will dissolve by merger with other companies, some will sell assets, while still others simply fail.

### Slot Machine

#### Slot Machines

Slot machines are considered more risky than stocks simply because the odds are that the total investment will be lost. In the case of stocks, most investors will either profit or suffer a partial loss. In the case of the slot machine, most players will lose their entire investment.

Of course, the reward of returning large multiples of the investment, make the slot machine attractive, assuming that one is not tempted to reinvest profits.

### Margin Trading

#### Margin Trading

Considered the highest risk, Margin Trading permits the investor to put more at risk than the investment itself. Using a margin account, profits can be magnified but so can losses. \$100 invested through margin can produce enormous profits but can also cost the investor \$500.

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