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Training the Investor Brain: Rethinking Risk and Return Expectations

The field of behavioral finance—the science of decision-making as it applies to investing—has many practical applications to help guide rational, long-term-focused decisions. Here, we look at how we may view risk and return.

Rethinking Risk and Return

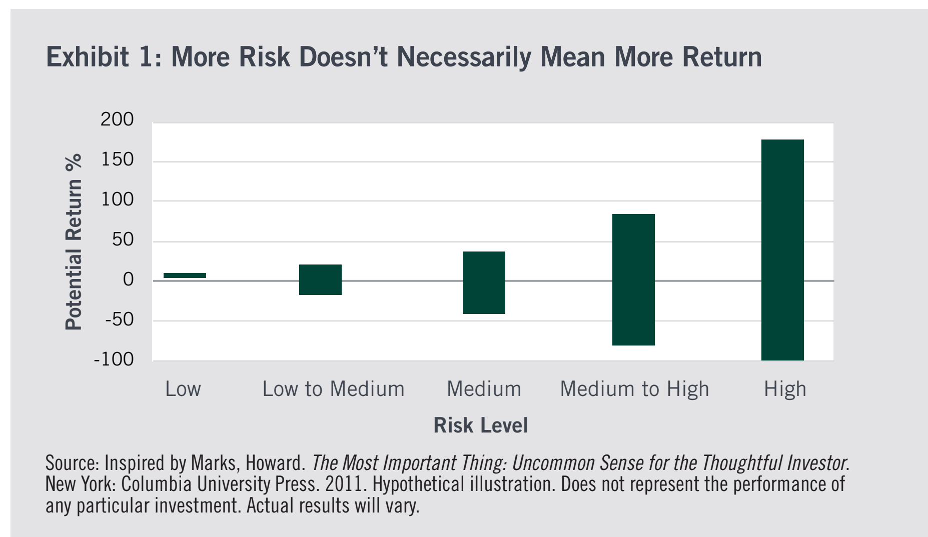
1. The relationship between risk and return is not linear.
2. Risk may be defined as the potential to lose money over the long term.
3. Stocks became less risky the longer the investor stayed invested.

More Risk Doesn't Necessarily Mean More Return

Consider the common understanding of risk and return. Most investors, if asked to literally illustrate the relationship between these variables on a blank chart with an X and Y axis, likely would draw a straight line that slopes upward from left to right. The upward slope would suggest that taking more investment risk directly equates to obtaining higher returns. While most people—even many investment professionals—believe this would be accurate, taking more risk doesn't *necessarily* mean more return. Think about it for a moment.

If investors *always* were rewarded with better returns when taking more risk, then achieving returns wouldn't be risky. The relationship between risk and return is not linear.

Exhibit 1: More Risk Doesn't Necessarily Mean More Return



Source: Inspired by Marks, Howard. *The Most Important Thing: Uncommon Sense for the Thoughtful Investor.* New York: Columbia University Press. 2011. Hypothetical illustration. Does not represent the performance of any particular investment. Actual results will vary.

As shown in Exhibit 1, risk can be expressed in terms of potential outcomes. For example, the range of potential returns for very low-risk investments (such as certificates of deposit) tends to be narrow—and positive. As investors take on higher levels of risk, the chance of achieving higher returns increases—yet so does the potential for losing money. We believe this offers a more realistic way to view risk and reward. It also may offer a practical definition of risk – the potential to lose money over the long term.

Risk Tends to Diminish Over Time

Adding time as a factor in the relationship between risk and return validates the notion of maintaining a long-term investment perspective and paying less attention to short-term market "blips," as shown in Exhibit 2. In fact, adding time to the same illustration shown in Exhibit 1 literally turns the picture upside down.

...time and market history were on the side of the investor...

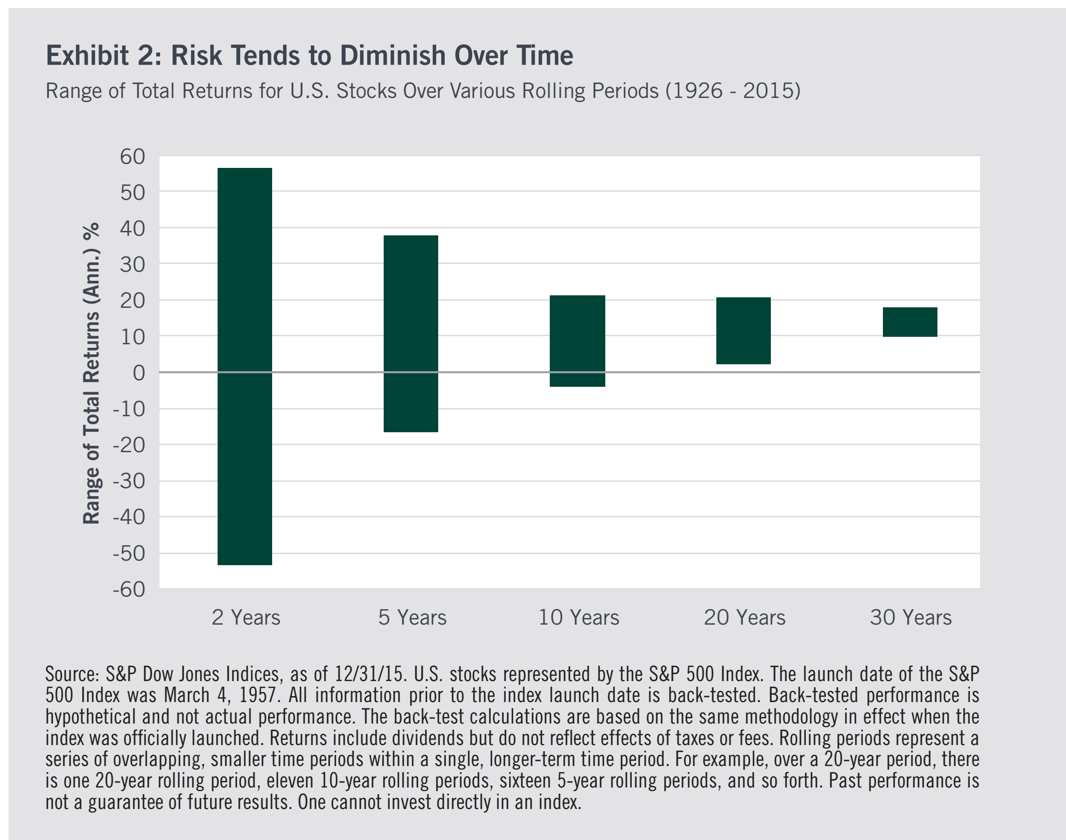


Exhibit 2: Risk Tends to Diminish Over Time

Range of Total Returns for U.S. Stocks Over Various Rolling Periods (1926 - 2015)

Source: S&P Dow Jones Indices, as of 12/31/15. U.S. stocks represented by the S&P 500 Index. The launch date of the S&P 500 Index was March 4, 1957. All information prior to the index launch date is back-tested. Back-tested performance is hypothetical and not actual performance. The back-test calculations are based on the same methodology in effect when the index was officially launched. Returns include dividends but do not reflect effects of taxes or fees. Rolling periods represent a series of overlapping, smaller time periods within a single, longer-term time period. For example, over a 20-year period, there is one 20-year rolling period, eleven 10-year rolling periods, sixteen 5-year rolling periods, and so forth. Past performance is not a guarantee of future results. One cannot invest directly in an index.

Exhibit 2 shows that in looking at U.S. stocks—a "risky" asset class by most standards—the chance of losing money tended to diminish over time. The range of actual outcomes, dating back to 1926, narrowed significantly the longer one remained invested. Over rolling 2-year periods, annualized returns were as high as 50%+ and as low as negative 50% (or worse). Looking at rolling 5-year annualized returns, the range of returns became smaller. And the trend continued with rolling 10-, 20- and 30-year periods.

In fact, by 20 years, the worst return was still positive, suggesting that time and market history were on the side of the investor (although past performance is never a guarantee of future results). Again, if we define risk as the chance of losing money over the long term, then stocks became *less* risky the longer the investor stayed invested.

Ask Yourself Two Key Questions

Exhibit 2 shows that staying invested longer meant better chances for enjoying gains. However, dispelling common misperceptions about risk also requires acknowledging realistic chances for losses in the short term.

Look at Exhibits 1 and 2 and consider this question:
"The longer you were invested, what happened to the likelihood that you would have experienced a really bad 2-year stretch?"

The savvy investor may realize that the 10-, 20- and 30-year numbers displayed in Exhibit 2 *include* a number of 2-year returns that were negative. Developing a realistic understanding of returns may require putting short-term negative returns into context and reflecting on the natural cycles of ups and downs that stocks have experienced. Again, investors weren't likely to achieve high 20-year returns without the possibility of poor 2-year returns along the way. The two outcomes were not mutually exclusive. So when investors experienced short-term losses, chances are they were still on track to achieving their long-term goals.

Behavioral Test: Two Questions

1. Looking at Exhibits 1 and 2, what happened to the likelihood of experiencing a really bad 2-year stretch of returns the longer you were invested?
2. What is the range of returns you expect to see in the stock market over the next year?

Also think about the following question:
"What is the range of returns you expect to see in the stock market over the next year?"[1]

Remember that over the rolling two-year periods shown in the exhibit above, there were times when annualized returns were -50% and +50%; one-year returns (not pictured) were even *more* volatile. So if you did not include a *negative* number in the potential range of outcomes you expect over the next year, you are likely not looking at risk realistically.

Having realistic expectations for stock market returns means understanding how risk and the stock market tend to work—and that negative short-term returns have been a part of achieving solid, long-term results.

The S&P 500 Index with gross dividends measures equity performance of 500 leading companies in industries of the U.S. economy.

A certificate of deposit (CD) is a savings certificate with a fixed maturity date and specified fixed interest rate. Issuers tend to restrict access to the funds until the maturity date. CDs generally are issued by commercial banks and are insured by the FDIC up to $250,000 per individual.

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[1] From Jay Mooreland at TheEmotionalInvestor.org