Sound Financial Bites 024 - Loss Tolerance

Episode Transcription

> *"We've been programmed to think that risk = returns, but it doesn't."*

Hello, this is Cory Shepherd, vice president of Sound Financial group and I'm excited to welcome you to Sound Financial Bites, where we bring you bite-sized pieces of financial knowledge to help you design and build a good life.

Hello and welcome to Sound Financial Bites. I'm your host and president and CEO of Sound Financial Group. My name is Paul Adams. It's great to be with you wherever you are virtually today. It's an early morning where I am in our studio here in our offices sipping a cup of coffee and looking forward to sharing some thinking with you today. Today's podcast is going to be on loss tolerance versus risk tolerance, and what really our industry does normally and what a lot of the material you'd read out there does normally to a client trying to learn and engage about money.

But, before that, I just want to remind everybody, reach out to us. Shoot us a note on Facebook. Tell us what you want future episodes to be. We're always looking for ideas. If you know somebody that would be an amazing speaker, let us know. We've got some fun podcasts coming up. We're working on scheduling. We have a commitment from the gentleman, Oz. If you all are familiar, his name is Mark Geist. He is one of the soldiers in Benghazi who stood and held the CIA annex back in 2012 for 13 hours, and his story is told in the movie and book, "13 Hours in Benghazi".

So, I think you'll all really get a kick out of that. We're going to take a very, very different approach in our conversation with him about how his life's changed from being a warrior to really being like a celebrity that is being pursued and has had to change his life and career as a result of this unintended amount of publicity and attention that he's gotten.

We've talked about our new podcast philosophy. Well, we're going to have these -- like today is going to be a personal financial philosophy podcast, and then we're going to periodically do the analytical financial cast. Then you're going to hear, maybe from me or from an expert that I bring in that's going to be personal philosophy like how to better design and build a good life totally outside of your money conversations. This could be somebody who's doing something unique with their lifestyle or they're living radically within their means. This could be a personal coach, somebody who's going to talk about biohacking. Then we're going to have career and business philosophy, and we've naturally rotated these. We're just going to be more explicit about telling you which one each one is.

So, today is going to be personal financial philosophy. So, don't hesitate. Even during the podcast today, go to our website, download a copy of our book. If you haven't worked with one of our advisers, I can't encourage you enough to get on there, hit our contact form, or call our offices.

You can find us at www.sfgwa.com, and we would love to have that conversation with you, have one of our team walk you through our first 30-minute conversation because we have no idea whether or not the process that we use will be appropriate for you at this time. But, what we do know is 30 minutes carved out with one of our advisers will merit the time that you invest and we look forward to it. We've also got our live events upcoming you can see on our website and stay engaged with the podcast.

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Episode Transcription

So, let's get to the subject at hand today. I'm going to start with the distinction that happens a lot. You're going to hear me talk about loss tolerance. That's the title of today's podcast. Yet, what happens way too often is people get confused, because we talk about risk tolerance. The entire industry talks about risk tolerance.

But, what do you automatically think of if I say you've got to take more risk to get more...? You automatically fill in the blanks with return. "I got to take more risks to get more return. I've got to put my family and my fortune and everything else at more risk in order for me to produce a higher potential future outcome and meet my goals and objectives." Yet, your brain doesn't work that way.

When you're looking at a chart of numbers, separated from the real situations that you'll face with risk of investing, you will say to yourself in that moment, "Yes, I would like to do that." We saw it happen a lot not just in stock market investment. We saw that happen in real estate investments in the fervor of the mid-2000s right before everything fell apart. People were fine not only taking risk on the volatility of the actual real estate values, but they were going more full-on in that risk simply because they were throttling on with debt.

"Risk might equal a return."

So, they both had leverage and they had these volatility climbing values and saying to themselves, "It's all going to work out fine and I'm fine with taking the "risk"." But they weren't okay taking that level of risk. They were okay with theoretically taking the risk when the volatility was only on the upside. But, when the downside volatility occurred, whether it's real estate or stock market investments, people got scared.

Now, before we're done today, I'm also going to talk about what will really begin to restrict you mentally and put you on the wrong track financially, which is the upside volatility of other assets while you're in a strategy that's working. So, we'll circle back to that near the end. So, let's go back to this risk. Risk, we automatically -- we've been programmed by the financial marketplace, by the talking heads, by the books we've read that risk equals return. But, risk does not equal return. Risk might equal return.

Let me explain. If you put yourself in a situation where, if you're a golfer, and you took a golf club and you bring it back and you're like, "You know? I just think I want to hit this a little further." So, you go back to your bag and you grab a driver. Now, nearly every golfer is taking more risk hitting with their driver than they were taking hitting with their 7-iron. Because, while the ball is supposed to go further, there's also a higher likelihood that we might hit it off to the right or the left and put ourselves in the situation that will be terrible for our next loss.

So, we're taking risks, but there is a perceived upside return that we're taking when we use that driver. Yet, if you were to take that same driver and climb a hilltop during a lightning storm and just hold that driver over your head, you're taking far, far more risk, and yet there's little to no potential positive outcome coming from holding that club over your head. So, more risk does not equal more return. It might just equal more risk.

So, if we're pursuing risk equals return and we've been programmed that way, then you'll see why people chase individual stocks. You'll see why people roll the dice and get into real estate perhaps when they haven't done the research they should do, or have built a strong enough or bolstered their balance sheet enough to really be participating in real estate transactions like that.

"Wipe out the word risk tolerance. Say to yourself, 'loss tolerance'."

So, here's what I want to offer you for your thinking: wipe out the words "risk tolerance". In fact, every time you even read risk tolerance, one of the best things you could do is say to yourself, "loss tolerance", loss tolerance. Loss tolerance is how much am I okay with losing by being in this investment? How much am I okay with the market going down? If I put in a million dollars today and that market goes to 800 thousand, am I okay?

Let's look at what the long run is going to look like. Again, whatever I'm investing in, if it's a globally diversified and academically allocated portfolio, then I'm going to go down and then I'm going to go back up. If it's real estate and we might be on a bubble and I'm thinking about buying a rental property -- by the way, I'm making no judgment of us being on a bubble today. Rather, I'm saying, at the moment you're doing it, perhaps you say to yourself, "We might be on a bubble."

So, if you're doing that, you say, "Okay, I'm going to take a million dollars, put it into various real estate properties and acquire 4 million dollars of total real estate." How much is the upside and what is the loss side? How much could this go down. Well, gee, if real estate prices went down by 20%, I lose almost everything. Almost everything I put in, all million dollars is gone because it wipes out the equity that's at the top of the value of each of those transactions. Our equity is always at the high end of the real estate value and the bank's ownership of those properties is always at the bottom. So, when it comes down, it's always our money that gets lost.

So, when I look at that and then I say, "Ooh, wait a second. I'm not sure I'm okay with that kind of loss and volatility." Well, let me step back. What's the average growth of real estate over time? Now, you guys can just Google that, make your own assessments. But, the average growth in value of real estate is not that high over very long periods of time. Though we can be kind of fooled if we're in a metro market and you live in that metro market, and you're like, "Oh my gosh, look how home prices have climbed here," and yet that is an anomaly that is happening right now that may or may not continue ad infinitum.

So, we just have to reflect what's the upside because that's why we're doing most anything is for its upside, the upside volatility. But, what is my loss tolerance on the downside volatility. Because, most of the time, what's going to happen is we will have very real losses if we can't stay in the portfolio. Now, here's something that is commonly said in our industry's educational online get a designation educational material.

So, my vice president, Cory Shepherd, sent me a text this weekend, and the text said something to the effect of, "Traditional planner speak says as a client, they're willing to accept additional risk to achieve higher rates of return." I think that makes sense, and if you're working with a financial adviser, they may have actually said that to you like, "Are you willing to accept additional risk to achieve higher rates of return so that you can fulfill your objectives?" Like you can't achieve your objectives at the current level of risk that you're currently taking.

So, what we're going to do is throttle up the risk a little bit, and then you might have a better chance of meeting your objectives, and yet here is what we would say. Our translation of that would be, "In order to get to where I want to go, I'm willing to accept a greater probability of not getting there at all." Let me say that again. Our translation of that, in our firm, would be saying, "In order to get to where I want to go, I am willing to accept a greater probability of not

getting there at all."

Now, why is that? Because, if we put ourselves in a position we're taking risks that we shouldn't take -- now, it could be stock market risk, it could be other kinds of risk, like saying I don't want to own disability insurance because I'm going to take that money and save it. Instead, it's going to help me with my retirement. Or, I'm not going to own an appropriate amount of personal umbrella policy or life insurance. Or, I don't want to leave as much money in liquid savings, because if I leave a lot of money in liquid savings to make sure that my family is safe, then that's going to diminish rates of return enough that I think it's going to compromise my long-term wealth building.

All of those things are additional risks to deviate from appropriate strategies in protection and keeping enough cash on hand. But, then there's also the type of risk that is, perhaps, given your loss tolerance, you should be at a portfolio that's 30% bonds and fixed income, and 70% equities. Well, if that's you and then you look and say, "Well, I can get an extra 1% rate of return by going up to 90-10, 90% stocks, 10% the fixed income that bond part of the portfolio.

Now, you're taking more risks than you should, which may have you break strategy altogether because your loss tolerance wasn't really tested. If your loss tolerance wasn't tested, you're put in the position where when the market goes down, you're now in irrevocable territory where you feel you have the need to liquidate and sell.

Here's what I want for all of you: I would rather whoever your adviser is. If it's somebody with us, we hope that they're doing this with you every time you engage them. If it's somewhere else, we hope it's an adviser that has the same kind of courage to have the confrontational conversation with you about the things that are really meaningful. So, it's an easy out. It's an easy out for the adviser to say, "You know, you probably just need to go ahead and crank up your risk." Because there's nothing that really has change in your life. It almost seems like a magical pill, like I'm going to throttle on more risk and more return is going to show up.

But, you might well diminish the likelihood in real terms of you reaching your objective why because you're more likely to be in a situation where you will abandon strategy. So, here's what we'd ask you to do. Ask if your adviser -- for yourself, just ask yourself, is your adviser really having a hard conversation with you? Like, are they having a conversation about the fact or are they talking about talking throttling up risk instead of the hard conversation with you that you need to increase the cash flow you're putting toward your balance sheet.

If you guys haven't had a chance to yet, look at our YouTube channel and we did a talk that was "cash flow trumps rate of return", and it's all about how you can excel and be more effective financially if what you focus on is how much money from your income flows onto your balance sheet, and that will outstrip rate of return every single time, but nobody talks about it because it's a hard conversation to have.

If the advertisers for Mercedes are saying, "You set aside more money and we get you a really awesome car: leather interior, all these safety features, it's super-fast, it's European. Don't you want that? You'll look great, people are going to like you more. You're going to have more friends." That's that advertising. As to be competed with, if you take that same amount of money and set it aside, you're going to be more secure in the long run. That marketing play doesn't play nearly as well. It's much better for a mutual fund company to advertise a lot of analysts, or here's a cool investment we made inside our mutual fund, and try to attract your

money that way.

That's what we want to put you in the position of is that we would rather be carefrontational with you having the hard conversations, not to make you do anything, but rather to put you in a position where you really know what the consequences of each decision are, so that you make each of those decisions with full knowledge.

So, so far, all we've talked about is that loss tolerance -- your loss tolerance, your fear of loss, the fact that your portfolio goes down might put you in a position where what you would do is make a bad decision that would lock in losses and, really, what causes those losses, I want you all to think about this, reflect on it, what caused the losses in the portfolio was not the date the client made a terrible decision to sell. I argue to have you consider that, instead, what happened was we had the problem back when the client took the risk that they shouldn't have taken.

So, it wasn't made that day in September of 2008 when the market fell down. That's when the math occurred. But, the mistake that caused that problem was the one that happened in the Spring of 2007 when they met with their adviser with the mindset that more risk equals more return without a full reflection of what their loss tolerance would be, and could they weather the storm going through the S&P 500's large debt and then climb back out of it. Can we weather those storms? If we can't weather the storms, then we know we're going to lock in losses at the worst possible time.

So, that's one way people break strategy that's dominated most of our podcast today. But, I promised we would talk about another thing that causes a break in strategy. What also causes a break in strategy is probably some of the most sinister things that can happen to us, and that is the allure of other things we can put money into.

Let me explain. We talked about the mistakes happening and what really causes the losses in a portfolio are actually the things when we made the decision. When we made the decision that we're going to set money aside with more risk and then the losses occurred later because we put it all in a portfolio that was more risky than it should have been.

So, let's go back to the mid-90s. In the mid-90s, if you had a globally diversified, academically allocated portfolio, it was doing great. It had years where an 80-20 portfolio, 80% stocks, had 20% years, 17% years, but it also had years that were single digit at the very same time that you looked to your left and right and you're like, "Oh my gosh, the NetNet fund," which was actually the name of an internet mutual fund, "climbed 300% in a single year." Three-hundred percent that these other stock market investments were going incredible. Most of them heavily invested in the NASDAQ.

We had friends who had bought some internet stock that was now going through the roof that they had bought online on whatever the new tool was at the time that people could buy from -- I don't know if you guys remember the pagers that you could actually trade from. That was that fervor going on around us.

So, if you had a globally diversified academically allocated portfolio and you were efforting to be a disciplined investor, here's what happened: everybody around you, basically, made you feel like a fool because they were getting all these wonderful rates of return and you weren't, and people shifted their portfolio.

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You see, when the internet bubble burst, that globally diversified academically allocated portfolio didn't drop that much. I think it was like 10 or 12 percent. It wasn't that -- even if it's just a composite index, no adviser involved at all, that portfolio dropped a downright tolerable level. It would be like being in the eye of the storm while everybody else is getting shredded by the winds and you're just standing there peaceful as could be because you didn't have all that loss in your portfolio because you really reflected on your loss tolerance and stayed disciplined, stayed diversified.

Now, let's take what happened to the people that were in like NASDAQ or in some of those stocks. Some of those stocks went to zero. Some of those companies don't even exist now, many of them. The NetNet fund doesn't even exist now. Those things really put us in the position where people were totally wiped out, but where they got wiped out was not during the downturn. They broke their discipline strategy. That comprise them being able to design and build a good life during the times of boom, not in the times of bust.

So, now what's happening? Well, we see real estate's starting to climb again. So, what do people do? They say, "Well, man, maybe I need to liquidate everything in my investments and go buy real estate now. Look how it's climbing." Nope, what I would say is let's sit back and say, "Does your strategy need to change?" Maybe. If, now, you have an interest in real estate and you want to have a disciplined strategy toward building real estate, then work with whoever your adviser is. To take 20% of your portfolio out from underneath that type of management where it's just equities, stocks, and bonds, and instead say, "I'm going to carve off 10% of my portfolio, 20% of my portfolio," and that is going to be my real estate portion of my portfolio.

Now, here's what's key. If you do that, and to maintain your risk profile and your loss tolerance, then what you would need to do is every time real estate climbed and you rolled it over to another piece of property would be to take whatever what it grew beyond the 20% and allocate it back to the rest of your portfolio just like we would in rebalancing any portfolio that was all just equities and bonds. You should be rebalancing between these other outside assets and your other portfolio, otherwise your risk tolerance is going to drift.

If you're working with an adviser right now that's not looking at things like your real estate holdings, looking at things like how much debt you're carrying and helping that inform their advice to you as to what you should have in your investment portfolio with them, I would highly encourage you to engage one of our team, or at least have a very frank conversation with your existing adviser.

I want to thank everybody for being on today. This has been fun. I love talking about the subject of loss tolerance versus risk tolerance, and if what you can do is just reread everything as "loss tolerance is key; risk tolerance is not", risk tolerance is a made-up term that can pull us in to taking more risk. If you reflect on loss tolerance, you are more likely to make investment decisions that will put you in a position where you won't overextend your family, you won't overextend your capital, and you'll more be able to hold strategy in every financial decision you make. We look forward to hearing from you soon. I'm so glad you could be with us today, and I hope today's podcast contributed to you being able to design and build a good life.

Hey, this is Cory again. I just wanted to say it's been great to have you here listening to this

episode. You can find out more information about us on our website, www.sfgwa.com, or you can find us on Facebook under Sound Financial Group. We'd love to hear any questions or comments from you there. Who knows? You may hear one on a future episode. For our full disclosure, you can go to description of our podcast series, this episode's description, or our website.

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