



## Three Steps to Talk About Risk

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Among the most important things that good advisors bring is the ability to help clients make the right trade-off between risk and return ... and to help clients understand the critical relationship between the timeframe over which they hold investments and the volatility they experience.

One of the most important conversations these days is about the amount of risk that clients should take in their portfolios.

Always an important issue, recent markets make this especially critical. Here are three steps to make that conversation an effective one.



### **Step One: Talk about long-term returns**

Start by reminding clients of after-inflation returns for different investments for the 84 years from 1926 (as far back as we have really good data) to the end of 2009.

This compares large-cap US stocks to intermediate, 5-year Government bonds and T-Bills. Frame this in terms of real, after-inflation returns – what really matters to clients investing for retirement.

After inflation, stocks have returned three-times more than bonds and ten-times more than T-Bills.

Then translate that return into the impact on client portfolios.

Based on historical experience, for someone investing \$100,000 in stocks over the average 20-year period, the after-inflation appreciation of \$259,000 is almost five-times that in bonds and almost 20-times the gain in T-Bills, which just barely beat inflation.



	Average real return (after inflation)	\$100,000 compounded at this rate for 20 years – in today's dollars	
		Ending Balance	Appreciation
<b>U.S. large cap stocks</b>	6.60%	\$359,041	\$259,041
<b>Government bonds</b>	2.26%	\$156,356	\$56,356
<b>T bills</b>	0.64%	\$113,609	\$ 13,609

### Step Two: The odds of losing money

Next, talk to clients about the historical experience of losing money in stocks after inflation, based on different holding periods.

Historically, holding stocks meant that after inflation you lost money about one-in-three years.

Looking at three-year periods reduces the chances of losing stocks to about one-in-four.

Over ten-year timeframes, investors lost money 12% of the time – based on the experience since 1926, you have to go out to twenty years to completely eliminate the chances of losing money in stocks.

#### U.S. Large-Cap Stocks: Real Returns

	Winning years	Losing years	Percentage of time lost money
<b>One year</b>	57	27	32%
<b>Three years</b>	63	19	23%
<b>Ten years</b>	66	9	12%
<b>Fifteen years</b>	66	4	6%
<b>Twenty years</b>	65	0	0%

### Step Three: Communicate this visually

Finally, portray the nature of the experience in a way that investors can relate to.

To do that, I worked with Michael Nairne and his team at Tacita Capital to convert data from Morningstar's Encorr database using the Ibbotson SBBI Large Company Stock index into a number of charts, showing returns over 1, 3, 10, 15 and 20 years. These charts can be found at the end of this article.



The first chart shows 1-year returns – it has extreme spikes; if this was all that investing in stocks entailed, most investors would bail out right there.

The next chart shows rolling 3-year returns – still a bit of a roller coaster, but less so.

The third chart shows rolling average returns for 10 years – by the time you get to 10 years, the level of volatility is still more than many clients would like but also a level that most can tolerate.

You can go on to show these charts for 15 and 20 years, which show volatility at a progressively lower level – but you risk losing buy in from clients for whom thinking even ten years out is a stretch.

### **How this conversation might go**

Here's how this conversation might go.

Start off by reminding clients that over the long run and after inflation, U.S. stocks have earned over 6% annually, even after the disastrous stock market events of 2008 and early 2009.

Then, point out the dramatic difference in long-term returns between holding stocks, bonds and cash.

Go on to say: “The downside is that if you invest in stocks, we know that you’ll lose money about three-in-ten years and periodically you will lose more than 20% in a calendar year”.

Don't say “You might lose 20%”, you say “You WILL lose 20%.”

Go on to say: ‘And twice, these 20% declines occurred two years in a row.’”

Explain further: “We know this because in the 84 years since 1926, stocks have lost 20% or more eight times after inflation – so about one-in-ten years.

Three of those were in the 1930s, then in 1946, in 1973 and 1974 and most recently in 2002 and 2008”.

Then show the chart with 1-year returns – and spend some time talking about it

Continue on: “The good news is that the longer your holding period, the less you have to worry about this – the extreme ups and downs disappear and the tops and the bottoms on returns get cut off.



“Here’s what returns look like over a three-year time frame ... and then ten years.”

And depending on the client, you could also show them the 15- and 20-year charts.

When you’ve finished, you can have a useful conversation with clients about their timeframe, risk tolerance and ability to sleep at night.

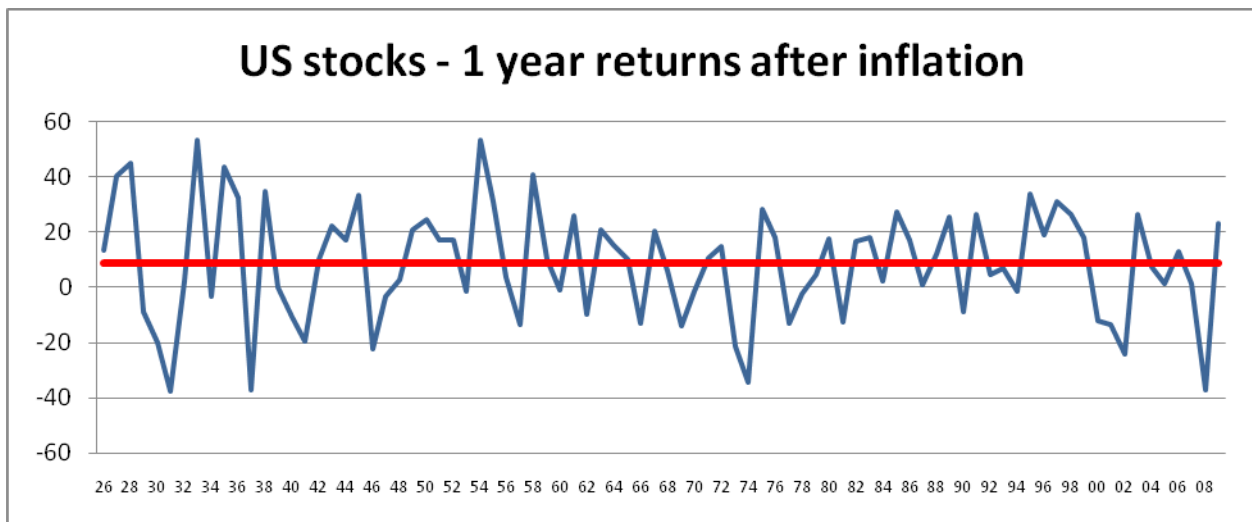
Your objective in talking to clients should be to explain things in a way that is not just persuasive and easy to understand – but also to communicate in a way that they’ll remember.

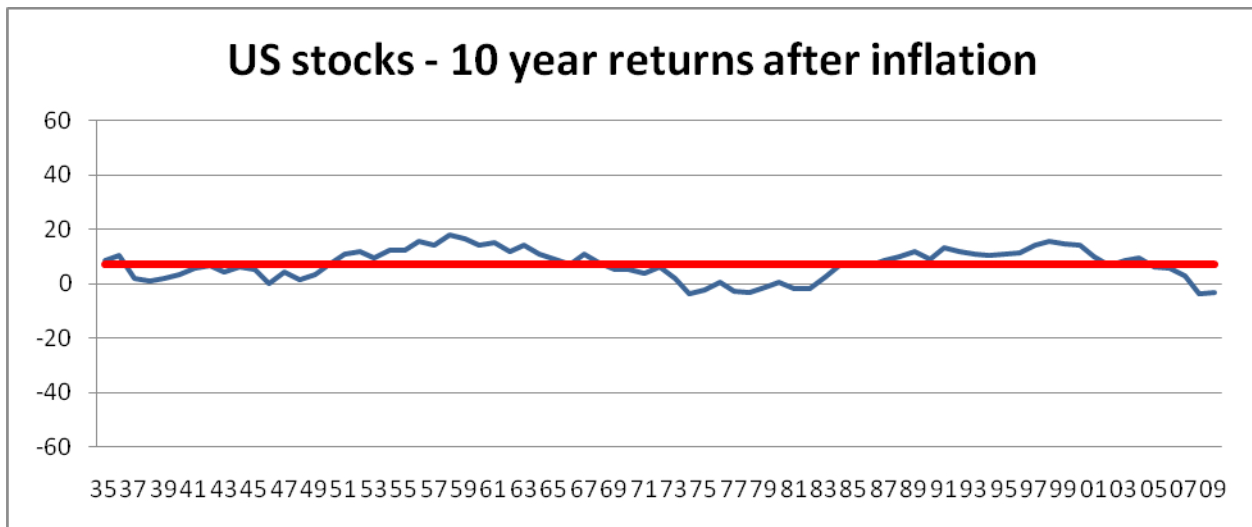
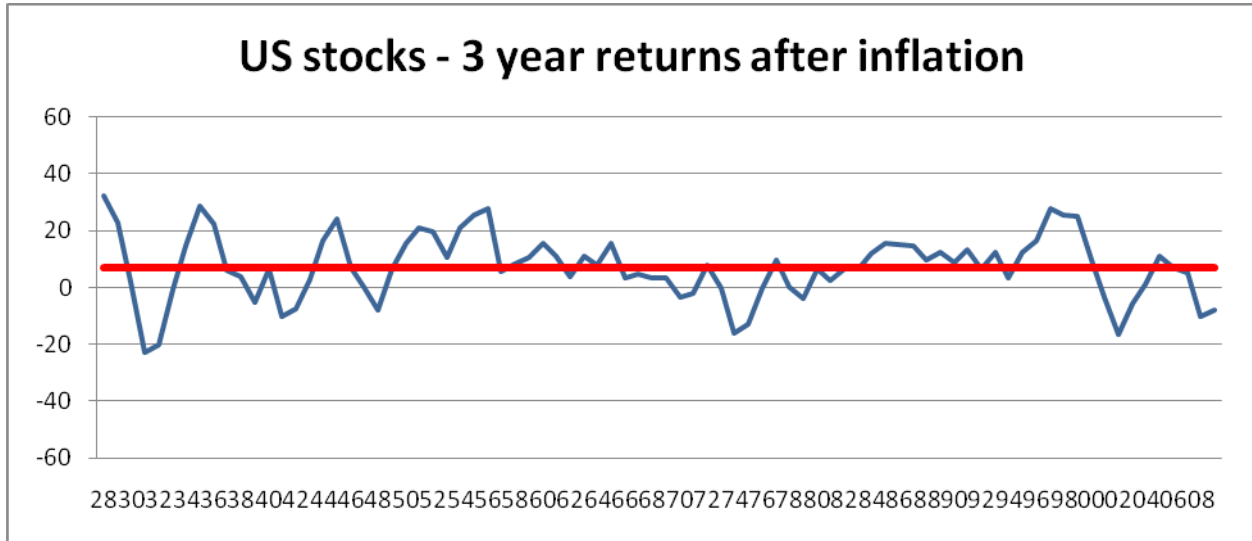
To do that, you have to connect at both a rational and an emotional level, only by making an emotional connection will our message really stick.

For your message to penetrate, find your own set of words to show that for investors with a timeframe of ten years or more, history truly is on their side.

Use charts such as these to backup that story – pictures truly do communicate in a way that words or numbers alone never will.

### US Large Company stock returns after inflation, 1926 to 2009





Source: Ibbotson SBBI Large Company Stock index, Morningstar Encorr database  
 Average= \_\_\_\_\_ (red line)

*Dan Richards conducts programs to help advisors gain and retain clients and is an award winning faculty member in the MBA program at the University of Toronto. To see more of his written and video commentaries and to reach him, go to [www.clientinsights.ca](http://www.clientinsights.ca).*

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