



Quick Q & A #26

Q: Can investors control risk?



A: No, but they can control their own behavior.

As the graphic above illustrates, investing involves many kinds of risk. The risks shown in black are “built-in” – facts of life for investors wishing to participate in the potential returns of debt or equity markets. Investors need these risks if they hope to beat the low returns of T-bills and savings accounts.

But other risks, shown in red, are introduced by the behaviors of investors themselves. These are “uncompensated risks” – exposure to these risks does not earn investors higher expected returns.



Market timing risk results when investors try to jump in or out of the market, hoping to ride the ups and avoid the downs. Because market moves can't be systematically predicted, market timing can leave investors out of the market when values rise.

By the same token, an investor with a large exposure to a **single stock** can be blindsided by poor earnings, accidents, scandal, or other negative surprises. As millions of investors have learned in recent years, holding a large percentage of one's assets in a single disastrous stock – such as AIG, Lehman, GM, and many others – can ruin one's financial future. Owning too much of one company is a needless gamble.

Built-in market risks can be moderated – but not eliminated – by careful asset allocation and diversification. Behavioral risks, however, can be completely avoided simply by steering clear of dangerous investment tactics.

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