March 31, 2006

## Risk and Return

Stocks began the year with a positive first quarter. Bonds struggled during the quarter as the Federal Reserve continued on their path of raising interest rates. With the bond market achieving low returns over the past couple of years, many investors have been readdressing their risk tolerance and considering asset allocation changes in their portfolios. In this letter we will address risk and when taking more or less risk is in order.

The average person defines investment risk as the possibility of losing money. Stocks, by their very nature, carry more risk than bonds since they can fluctuate so much from month to month. While bonds fluctuate with interest rate changes, they are much less likely to lose money than is a stock. In contrast, those of us in the investment industry define risk as the volatility of investment returns over time, which can be measured by their standard deviation. This allows us to measure the degree of risk, not only of individual securities, but also of the individual security’s impact on the overall risk of the portfolio.

Our objective when we are formulating an investment plan is to determine how much risk needs to be taken to reach the investment goals that each of our clients have. Ideally, we want to take as little risk as needed to reach these goals. We also reconcile the amount of risk that needs to be taken with the amount of risk that individuals are comfortable taking. It is important to remember that there are risks in not taking enough risk just as there are risks in taking too much. Determining the proper amount of risk is an important first step in the investment process.

While it is tempting to want to own stocks while the stock market is rising and to own bonds when the stock market is falling, in reality it is impossible to make these shifts with consistency. Every credible study conducted on market timing proves that it can not be done consistently, and even if it could be, transaction costs and taxes would eliminate any benefit. A client’s long term asset allocation takes into account the normal cycles of the markets. While short term tactical shifts in asset allocation are made based upon our forecasts, it is unusual to make major changes to the long term, or strategic, allocation. Major life events such as retirement, death of a spouse, or receiving a large inheritance are the normal reasons for major shifts in risk tolerance.

Please feel free to contact us if you would like to review your investment plan to ensure that the investment plan we are following for you is the correct one to meet your investment goals as well as your risk tolerance.

**Wabash Capital**