Financial Literacy

Part 4

Risk Adjusted Returns

Market Snapshot

Closing Values as of 04/26/2019

Dow	26,543
S&P 500	2,940
Nasdaq	8,146
Gold	$1,289

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Risk Adjusted Returns & Real Returns

Risk adjusted return is a measurement that describes relative risk and how investment returns compare to investments of similar risk. By considering risk adjusted returns an investor is able to evaluate whether and investment or portfolio is providing a reasonable amount of return for the amount of risk being taken. Understanding your overall risk adjusted return is an important part of evaluating your investment choices and whether your portfolio is capable of meeting your long term investment needs.

We have all heard the maxim "the greater the risk, the greater the potential return". This maxim seems to imply an investor who wants higher returns only needs to take greater risks to achieve those returns. Although it is true that many higher risk investments experience greater average returns over time, it isn't true that simply being willing to own higher risk investment will result in higher long term returns. There are factors other than risk that can influence an investor's rate of return. One such factor is an investor's ability to remain invested over the long term, through good times and bad. As I mentioned in our first financial literacy paper, it is normal for investors to want to take excess risk when they feel good and feel the urge to sell everything when they feel bad. If an investor has taken on too much risk for comfort they are unlikely to be able to remain invested long enough to realize the types of returns they set out to achieve …or worse, they might experience substantial losses.

Rather than focus solely on how much or how little your return is (total return) it may be more useful to evaluate your returns in terms of how much risk was taken to achieve them. Ensuring your portfolio's level of risk is consistent with your personal risk tolerance and that your portfolio's performance is consistent with its risk profile is more important than simply comparing returns to a market index. A portfolio that has less risk than the broader stock market should be expected to have a lower potential return as well, so comparing your portfolio return to the return of the broader market does not tell you whether your portfolio is performing as well as it should.

There are several ways to calculate risk adjusted return, some appear to provide conflicting results so it is important to use a consistent method when evaluating risk adjusted returns. Generally speaking, calculating risk adjusted return involves subtracting the "risk free" rate of return then dividing by the investments standard deviation (or any other measure of investment risk). The so called risk free rate of return is the rate of return you might get from investing in US treasuries (a "risk free" investment because treasuries are backed by the full faith and credit of the US government). Standard deviation is a statistical risk measure that measures volatility of returns relative to the investments average return.

A Word About Market Highs

On April 23rd the S&P500 closed above its previous closing high of 2930. Given relatively strong earnings and the recently reported 3.2% Q1 GDP it is likely markets may go on to set even higher highs before they experience a major correction. How high the markets will go, when and how far they will fall are questions every investors finds themselves asking. While answers to these questions may make you feel better they shouldn't cause you to significantly change your investment strategy. Understanding your personal risk tolerance and keeping a long term perspective will help you to avoid taking on too much risk when you feel excited about recent highs ...and avoid selling good quality assets when you feel scared during the next downturn. Market highs provide an opportunity to rebalance and lock in gains or to raise cash for short term needs.

Rather than celebrate the new highs by running to invest more money in the next hottest stock, now is a good time to recall the old maxim "don't own anything today that you wouldn't want to own during the next bear market". Your focus today should be on owning quality and maintaining a properly balanced portfolio