Principle 3: Never bear too much or too little risk

[Applause]

Jim Dahle: Our next speaker is Alan Roth, MBA, CPA, CFP. He has a lot more letters behind his name than I do. So he's at least four times smarter than me. I think this means that he is the founder of a fee only hourly financial advisory firm. He has 25 years of experience in corporate finance. He was the corporate finance officer of two multi-billion dollar companies, works as a consultant. He's the author of an investing book. He is a financial columnist for the AARP, for etf.com, for Financial Planning Magazine.

And most importantly my favorite reason why I like Alan is something he hasn't done for quite some time. This role he had as a columnist called "The Mole" where he went undercover in the financial planning industry and basically revealed all their secrets. So he hasn't done that for over a decade, but it's still my favorite role, Alan, and thank you for being here today.

[Applause]

Alan Roth: Skies are opening up when I talk. Yeah the mole was the most fun I ever had writing. Bear the right amount of risk. How do we typically determine the amount of risk to take? We take a risk profile questionnaire---and I know it doesn't seem like it today--but these are the returns of the Total US in blue, Total International in red, and Total Bond in yellow.

We are in the single worst nine months in bonds that has ever happened before but still bonds are a whole lot less risky than stock. By the way there are some wonderful opportunities in this bond route. Something like TIPs, a year ago you could earn a negative 1.6% return, real return. Today it's a positive 1.7%. So there are some really good things about this really bad bond market.

How do we typically determine our risk? Raise your hand if you've ever taken a risk profile questionnaire. Vast majority of people, me too. Well Jason Zweig of the Wall Street Journal will be here tomorrow, says they're worthless. And I say, Jason I completely disagree with you. They're not that good. They're actually dangerous. Why? Because the way we feel about risk is not stable. And the bigger one is they don't measure one's need to take risk.

I've taken risk profile questionnaires. I love to take them, and I get that I should be 70% to 140% in stocks. I should have a margin account. By the way what about—-would have happened to that margin account in today's market—-it would have been called. Okay, I'm 45% in stocks. Why? Because we've won the game. Our need to take risk is low

So there is a company that I think has the single best risk profile questionnaire out there. Not at liberty to mention their name but it starts with a V. So here is an example of one question. In 2008 stocks lost over 31%. If this happened again, what would I do? And I answered it truthfully. I would buy more stocks. Which is what I did in 2008.

But one, it was really really hard, And two if I were 80% stocks I never would have had the cash or the courage to buy more stocks back then.

So feelings about risk. Beginning of this year I'm hearing a lot of “I've got a long investment horizon so I'm comfortable being 100% in stocks.” Now I'm hearing “this has never happened before, bonds and stocks at the same time, I'm going all to cash until things settle down. I'm not panicking, this is logical.”

Irrational, they're panicking. So I want to make someone in this audience a hundred billion dollar bet, and I'd rather have some diversity rather than a white male. Okay, so who would take this bet, where there's a 99% chance of winning. If I tell you that if you lose, you die, your spouse dies, your children die. Probably wouldn't take that bet.

So we want to look at probabilities and consequences. So we typically ask how would you feel if your stocks lost 50%. Maybe the better question is how would you feel if you couldn't send your daughter to that prestigious college that you worked so hard to get into if you had to work another decade in that awful stressful job with that horrible boss. If you couldn't buy the lake house. So again, you have to think in terms of consequences.

So willingness to take risk. I know from a guy, getting in touch with your feelings sounds a little weird, but you really have to imagine what it would be like if things don't work out. Test the ability to rebalance in a bear. The only good thing about this bear market is that with bonds and stocks going down there's less of a need to rebalance.

I'm so cheerful. So you know I had a lot of people that say to me, “Oh no, no. I don't panic in a bear market.” And they come to me as clients and where did all these tax loss carry forwards come from. So in my opinion the biggest predictor of how someone's going to perform in the next bear market is what they did in the last bear market.

Some money and happiness. I'm really disappointed Jonathan Clements isn't here because he taught me so much about money and happiness. I don't know he put his family above me, I just don't understand that, but anyways if Elon Musk makes another billion dollars, yes he'll be happier. But when you lose money you get roughly twice as much misery as happiness from making money. Daniel Kahneman won the Nobel Prize for prospect theory on that.

So how much risk should you take? A 65 year-old with the 2 million dollar portfolio needs $50,000 a year above Social Security and the high willingness to take risk--they don't have much of a need--a conservative portfolio. The above with a million dollar portfolio, they've got to have it grow. So maybe take a little bit more risk. If they had a low willingness to take risk probably shouldn't take much because they will sell when stocks go down.

A 45 year-old saving for retirement with a high willingness can be aggressive. A low willingness, again conservative, because they're not going to stay. A 25 year old--I'm not a fan of 100 minus your age if they're saving money that they need in two years. Don't want to take a lot of risk with it. A 25-year old who just inherited 2 million, we don't know how he or she is going to behave.

So again, in the concept of taking risk, the only one that should have an aggressive portfolio is someone that has the high need. And as hard as it is to measure the high willingness to take risk-- and Carl Richards has it right--you know we buy high, sell low, we repeat till broke.

Never take uncompensated risk. 96% of stocks have earned, on average, the same amount as the treasury bill. There's a handful of stocks that drive the return. And guess what, I don't know what those will be going forward. And I'm going to brag I own Zoom before I even knew what Zoom was. Guess what? Vanguard Total Stock Index Fund.

Okay, what about asset classes with lower, negative correlations--commodity futures, foreign currency futures, options. Can somebody tell me the one thing that all three of these have in common? In the aggregate not a penny has ever been made before costs. There's someone on the other side of the trade.

Inverse S&P 500 funds, triple inverse S&P 500 funds, and don't laugh, I've had really sophisticated clients that were private equity managers, mutual fund managers that owned both an S&P 500 index fund and an inverse S&P 500 Index Fund. That's like

betting on both teams. You can't win through a bookie. Gambling half your net worth in Las Vegas would be more fun than many of these other things.

So lower, negative correlations isn't enough, you also need a positive expected long-run return. REITs sometimes have a negative correlation. Lately, as Christine Benz has pointed out, very positive correlation. Precious metals and mining funds--I think they're great--but you've got to have a stomach of lead to stay the course there.

Okay. The penalty for not knowing your risk.This is--I'm not at liberty to say the Chicago-based research company this came from-- but overall an individual investor underperforms the fund, not from fees because the fund has the fees baked in, by 1.73% By either performance chasing, not knowing our risk, etc.

So the old paradigm is on risk, if you can't be right, at least be consistent. But these are the three what I call the Second Grader Portfolios, or the Three Fund Portfolio from Taylor Larimore. Total US, Total International, Total Bond. And it's 90%, 60%, or 30% risky. And guess what? They all performed roughly the same.

So pick an asset allocation that's going to match your willingness to, and your need to take risk. imagine the pain of if things don't work out. Think of asset allocation as a binding contract. And I tell my clients I enforce based on guilt. You only wish a large New York law firm route to ruin your life by comparison. And when I disagree with the client I negotiate. For instance, in good times the client might say I want to be 70% stocks, and I think 60% is more appropriate, I'll say start with the 60%, and then if stocks go down into 20% below where they are today and your appetite is still there, then go to 70%.

I'm testing the resolve. I'm not timing the market. And guess what? How many clients come back to me in that bear market and said they want to increase. It's hard enough to get them to rebalance.