

# Quality Asset Management

*Grow Your Wealth with Peace of Mind*

## When are Stocks Too Risky?

*By Gil Hanoch, June 7, 2005*

In the article, "[Which is Safer for Retirement: Bonds or Stocks?](#)" (Hanoch, Nov. 2004), stocks were compared to bonds as an investment vehicle for retirement. The comparison was done using historic data and found stocks to be safer under certain conditions. You might ask yourself, "Are there certain circumstances, not seen in the past, that could make stocks too risky?"

In order to answer this question, we should first understand what stocks and bonds are and how they relate to each other.

**What is a stock?** A stock represents company ownership. When you own a stock, you own a part of a company. The company gets to use your money for its expenses with the goal of generating profits beyond the money spent. You are directly affected by the company's success: profits increase your investment value, while losses decrease it.

→ In the rest of this article, the terms "**stockholder**" and "**owner**" will be used interchangeably.

**What is a bond?** A bond represents a loan to a company (or a government). When you lend the money, you get a commitment to be paid back on a certain date and receive fixed interest.

As long as the company does not completely fail, you should get back the loan with the interest by the payoff date. No matter how successful the company is, you will get the exact predetermined amount: no more, no less.

→ In the rest of this article, the terms "**bondholder**" and "**lender**" will be used interchangeably.

**How do stocks and bonds relate?** The company takes loans hoping to increase its owners' investment. The company owners get the profits left after the company pays for all of its expenses, including loans.

Note the order: loans are paid off first; only the remaining profits are given to the owners. By getting paid first, the lenders enjoy greater security than the company owners in case of failure. The price for this increased security is limited profit: If the company enjoys great success, they still get the same fixed amount back, while the owners enjoy the additional profits.

**Why do owners get paid better than lenders?** When choosing between two investments with the same returns, people prefer the investment offering lower risk. In order to accept higher risk, people require higher returns. Since ownership involves higher risk than lending, it is compensated by higher returns.

**When are stocks too risky?** Stocks are too risky compared to bonds in most cases! Specifically:

1. Any **individual stock** is too risky compared to a bond, since any company can fail and declare bankruptcy. Usually, in such a case, the assets of the company can help repay part or all of the loans, but the owner may lose the total value of his/her investment.
2. Any stock or group of stocks **held for limited periods of time** can experience slow periods in which they are able to pay off loans, but are not profitable. In some of these cases the owner's investment can drop in value significantly.

**When are stocks safe enough?** There is one case in which stocks can be safe enough: a globally diversified group of stocks held for a long period of time. These two conditions are so important that I will repeat them separately:

1. A globally diversified group of stocks,
2. Held for a long period of time. (In the example below, 3 years were needed in the past.)

How do these conditions increase the security of stocks to an acceptable level? Let's assume that the universe of stocks all over the world grew more slowly than bonds over many years. In this new reality, the risk-taking owners would get paid less than the low-risk lenders.

If lenders were offered higher returns for taking less risk, no one would want to be an owner. Masses of people would sell their stocks and buy bonds. This would create a corrective chain of events:

1. The increased supply of lenders (bond buyers) would make it easier for companies to get loans, allowing them to offer lower rates on new bonds. *The returns on bonds would decline.*
2. The lower cost of loans would decrease the expenses of companies and, as a result, would increase their profitability. *The returns on stocks would increase.*

As long as people keep their nature of demanding higher returns for taking higher risks, the universe of stocks in the world should provide higher returns than bonds, if held long enough.

**Example.** An example of a portfolio that complies with the two conditions mentioned above is [Long-Term Component by QAM](#). As seen in the article "[Can the S&P 500 be dangerous?](#)" (Hanoch, Apr. 2005), the longest decline to recovery period of this portfolio since 1970, lasted less than 3 years.

Note that the historic data does not guarantee that future declines will not be longer, and other portfolios may (and usually do) experience longer declines. The logic in this article should give you comfort that future declines compared to bonds should be limited in time.

## To summarize

Human nature makes it likely that a globally diversified stock portfolio held for the long term should be the one case where stocks are not too risky. This gives people an opportunity to create great wealth, without taking excessive risks.

This article is an important supplement to historic data of a globally diversified stock portfolio. No one guarantees that any particular portfolio will not behave worse in the future, but it is reassuring to see how human nature should limit the length of underperformance of stocks.

Past performance may not be indicative of future results. Simulated data was used for periods prior to the inception of mutual funds (see [Performance Data Disclosure](#) at <http://www.qualityasset.com/disclosure.htm>). Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product made reference to directly or indirectly in this article, will be profitable, equal any corresponding indicated historical performance level(s), or be suitable for your portfolio. Due to various factors, including changing market conditions, the content may no longer be reflective of current opinions or positions. Note that services are limited to investment advice and do not include financial planning and/or non-investment related consultation services. You should not assume that any discussion or information contained in this article serves as the receipt of, or as a substitute for, personalized investment advice from Quality Asset Management. If you have any questions regarding the applicability of any specific issue discussed above to your individual situation, you are encouraged to consult with the professional advisor of your choosing. A copy of our current written disclosure statement discussing our advisory services and fees is available for review upon request.