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Patience and Discipline Reduces Investment Risk

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One of the most frequent questions I get as a financial planner is about the near-term direction of markets. These questions are usually prompted by something the questioner read or heard on financial TV. Interestingly, it is almost always a fearful question about large market drops and rarely an inquiry about the possibility of significant market gains.

Let's remember what we know and what we don't know. We know that about every three to five years brings a drop in U.S. stock market prices of at least 20%. We don't know when. We don't know how to figure out when it will happen. We don't know how to figure out when a drop in prices is likely to reverse. We know that having a diversified portfolio reduces volatility and even long-term risk. Finally, we know that (in the past every single time) the long-term trend of stock market prices is up. Given any long-term holding period (say over 10 years) you make money by being invested and disciplined.

Knowing the above makes the concept of risk very different when we consider our portfolios. Technically the term "risk" refers to the possibility/probability of a permanent loss. But we see the term applied regularly to the possibility of just short-term fluctuations in market and asset prices. So it is not unusual to see a portfolio mostly in stocks as being risky, when over the long term it is likely to offer the highest returns when compared to "safe, non-risky" fixed income and cash. (For related reading from this author, see: *Trying to Beat the Market? Consider These Steps Instead*.)

If we are committed, long-term investors (and I can think of no other way to be in the stock market), and prices are historically likely to rise with some time and patience, does volatility really mean risk? The answer is clearly no. Risk is not being subject to market price fluctuations unless you are forced to sell when prices are lower.

Here's a thought experiment. Was the severe drop in stock prices in 2008-2009 a reflection of risk? If you did nothing and just held your diversified portfolio as is, you are much wealthier now than then. If the market drops over 20% in 2017, does that mean you have risk in your portfolio?

Recall that risk is really defined as relating to the permanent loss of something, in this case money. Holding your portfolio in cash is in fact really risky over the long term. Inflation will clearly cause a permanent loss in purchasing power with each passing day. So which is riskier, holding all cash or all stocks? (For related reading from this author, see: *How Inflation Impacts Your Financial Planning*.)

Of course, it depends on having a long-term horizon filled with patience and the discipline to stay invested in a diversified and consistent manner. Thinking about risk when investing is crucial to controlling your emotions. Knowing and expecting volatility makes us all much better at achieving financial success in our lives.

(For more from this author, see: *How You Can Protect Assets With Umbrella Insurance*.)

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