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FACTORS IN FOCUS

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Fixated On Risk

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Sit down with your typical financial advisor or brokerage firm as they are about to pitch you their preferred products, and you'll get an ear full about historical *returns* with the presumption that those returns are indicative of future performance. From a marketing perspective, this is a smart approach. Investors want results and are drawn to the easy road like a moth to a flame.

What would a financial advisor emphasize if gathering assets or herding clients were not their exclusive focus? What if they were more concerned with the long-term outcomes of the clients they serve, and providing them the peace of mind to know they've done everything within their power to achieve those outcomes? Then the emphasis would be on an entirely different subject; a topic that investors don't like to discuss but absolutely must understand. They would be fixated on *risk*.

Understanding Risk

We talk about risk extensively with clients and prospective clients. At the plan level, we're focused on the risk that you won't achieve your long-term growth and retirement cash-flow goals; the risk you won't be able to provide a financial legacy to your loved ones. Each portfolio we manage is designed to minimize the chances that these risks come to fruition while understanding they're called risk for a reason—they can never be eliminated.

We're concerned with risk at the investment and asset class level as well. We know there are unnecessary or "bad" risks—those that increase uncertainty without also increasing the likelihood of a more favorable outcome. Jumping in and out of the market or holding an excessively concentrated portfolio are just two examples. But there are "good" risks too, fundamental risks that drive investment returns. Stocks are riskier than bonds, and in particular small cap and lower-priced value stocks are riskier than larger and higher-priced growth stocks. In each case, taking those risks have been rewarded with higher returns. These returns can be an essential element of achieving your goals. And without risk, these returns wouldn't be possible.

The important part about taking investment risk is that you do so in an intelligent way. Focus on the fundamental risks that you should get paid to and can *afford* to take. Equally important is that you avoid "bad" risks or risks you cannot afford. Make sure that you stick with your risks until they translate into the returns that you deserve.

Why Focus on Risk?

The benefit of applying this risk-based framework to investing is twofold. First, it helps to reduce surprises and knee-jerk reactions to unexpected events like bear markets or extended periods of small cap, value and global stock underperformance. Knowing that risk sometimes "shows up," and studying historical periods helps to alleviate fears of "this time it's different." It gives us the confidence to stick with our decisions until expectations and outcomes converge. Importantly, we are better positioned to avoid the significant costs of making emotional instead of informed investment decisions.

Second, it provides a guideline on how we should invest. Consider inflation risk. Most investors understand that they shouldn't own assets that do poorly when unexpected inflation occurs. Your future portfolio growth and retirement cash flows are sensitive to inflation; the more it rises the harder it is to achieve the real (inflation-adjusted) growth and income you require.

Under our risk-based investment approach, the first step in limiting inflation risk is a simple one: we minimize interest rate risk by excluding long-term bonds. With fixed coupons and maturities of two decades or longer, long-term bonds respond poorly to increases in inflation and interest rates. We don't believe their potential for (slightly) higher returns compared to short-term bonds is worth the risk in the safer part of our portfolios.

But some stock market investments also have a component of interest rate sensitivity. As rates have fallen in recent years, investors have flocked to different types of stocks: utilities, real estate investment trusts (REITs), dividend-based and "low-volatility" stocks. We've avoided these sectors and traditional index funds (like Vanguard) that include them, despite robust recent returns. We didn't want to expose our clients to a hidden form of interest rate and inflation risk embedded within these funds that might be at odds with their long-term goals. At the same time, we know value stock indexes, especially those that exclude these sectors (as DFA does), tend to perform well during periods of rising inflation, which is one of the reasons we tend to hold higher exposures to value stocks than other advisors and use DFA funds in particular.

TABLE 1 Asset Class/Fund	Total Return (7/8/2016 to 11/11/2016)
Fixed Income	
Vanguard Long-Term Bond Index	-9.7%
DFA Five-Year Global Bond Fund	-1.3%
Interest Rate-Sensitive Stock Sectors	
Vanguard Utility Index Fund	-10.7%
Vanguard REIT Index Fund	-12.0%
Vanguard Dividend Growth Fund	-1.5%
Powershares Low-Volatility ETF	-6.5%
Stock Asset Classes	
Vanguard S&P 500 Index Fund	+2.3%
DFA US Large Cap Equity Fund	+3.4%
Vanguard Value Index Fund	+4.3%
DFA US Large Value Fund	+6.7%
Vanguard Small Value Index Fund	+6.7%
DFA US Small Value Fund	+11.8%

source of data: morningstar.com

Evaluating Risk

Interest rates hit their low for the year in July and have risen almost 1% through mid-November, resulting in a loss of -9.7% for the Vanguard Long-Term Bond Index fund. Short-term bonds were less impacted, as the DFA Five-Year Global fund is down only -1.3% over this same period.

Table 1 above shows that it wasn't just long-term bonds that have been affected by rising interest rates. Utility stocks and REITs, due to their interest rate sensitivity, have done even worse, losing -10.7% and -12.0%, respectively. Dividend-oriented stocks and "low-volatility" stocks have lost ground as well, compared to the S&P 500, which has gained +2.3%. Clearly, if you thought bypassing long-term bonds was sufficient to minimize interest rate and inflation risk, you were wrong.

Even within diversified investment strategies, owning interest-rate sensitive utility and real estate stocks have hurt returns. The DFA US Large and Small Value funds have earned 2.4% and 5.1% higher returns than their Vanguard counterparts *in just four months*. Over the long term, excluding interest-rate sensitive stocks and focusing more consistently on pure small cap and value companies has led to +1% to +2% a year higher returns for DFA's asset class funds compared to Vanguard's index funds. If the last few months is any indication, and the markets return to a period of normalcy as opposed to one that excessively rewards long-term bonds and interest rate-sensitive stocks, we would expect this outperformance to continue.

Embracing Risk

Regardless of returns, *risk* will continue to be our primary focus with you. The big-picture **planning risks** that you are trying to avoid—running out of money or spending less than you deserve. The **market-level risks** that drive returns. We will evaluate the risks you can individually afford to take and the ones you cannot. We'll choose the specific portfolio strategies that target our desired **investment risks** and generate the expected returns necessary to achieve your financial goals. And we will try to **communicate these risks** to you in a way that helps you better understand what you own and why.

We believe a knowledgeable and disciplined investor, along with a well-designed investment portfolio that embraces the risks that drive expected returns is essential for achieving a successful financial experience.