RISK AS VOLATILITY OR AS OUTLIVING ASSETS

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I think there is a fundamental error in the thinking of personal-finance professionals. That error has to do with the definition of risk.

Personal-finance professionals seem always to define risk as volatility. I have never seen it defined in any other way. That definition makes sense in the short term. Let’s say that you and I both have $40,000, and we will need the money to buy a new car a month from now. You put your $40,000 in bonds; I put mine in stocks. Since stocks are much more volatile in the short term, I am at much greater risk of not having the $40,00 when I need it.

But as one’s time frame extends further and further into the future, the definition of risk should change. If you and I both have $40,000, and we will not need it for 40 years, then your all-bond position will likely earn only two thirds (or so) as much as my all-stock position. Stocks are not riskier than bonds, given a long enough time frame. Instead, the risk has now become not earning enough on one’s investments to enjoy a comfortable retirement.

In 2006, TIAA-CREF pushed all of its clients to have personal interviews with its financial advisors. During my interview, the eyes of the advisor perusing my asset allocations widened. “You’re 100% in stocks!” he exclaimed. “You have to be at least 40% in bonds.” I politely disagreed. “I’m 10 years from retirement,” I said, “and I hope to live 20 or 25 years during retirement. So I prefer a more aggressive allocation.” After a bit more back and forth, he called his supervisor, and for another five minutes they hammered at me that I must be more conservative. Finally, with glances at each other and smirks that said “You can lead a horse to water,” they gave me up to my foolishness. Now here it is 15 years later. I daresay that, even after two major recessions, their 60%-40% portfolio would probably have earned less than two thirds of my all-stock portfolio.

Risk is usually defined as volatility, but . . . *Time mitigates risk*. As a time frame extends further into the future, risk shifts from volatility to the danger of outliving one’s assets.