



## Why Risk Matters

The Indispensable Role of Advice

When it comes to evaluating the success of an investment plan, the average investor focuses on the end result—the performance of their investments. However, return is just one component of an investment process, and it is the one over which investors and their advisors have the least control. Risk on the other hand, or the likelihood of achieving a target return, can be managed. Because return and risk are inextricably linked, the success of any investment plan depends on strategies for managing risk. A structured investment process that manages risk and navigates through investor emotions highlights the value of advised investing.

This paper reviews the influence of emotionally driven behavior on investment decisions, the impact of risk management on investment strategy, and the importance of total portfolio risk management. Because emotions often play such a large role in making investment decisions, risk management is a practice that the average investor generally fails to implement successfully.

## Emotions: The heart of the matter

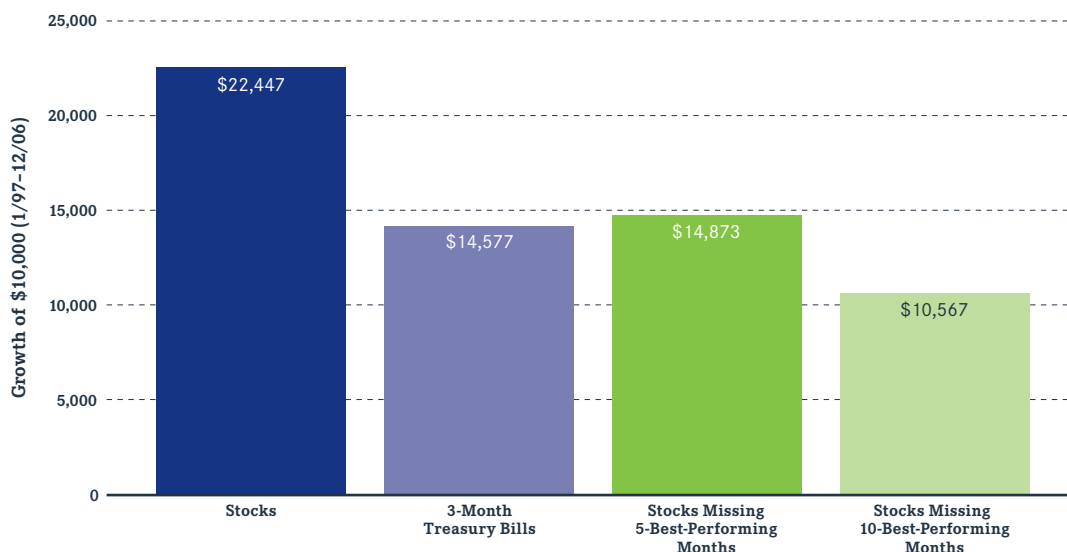
Fear and greed are basic, but powerful, human emotions. Both divert otherwise rational individuals into making irrational decisions. Nowhere is this more true than in the realm of investment decision making, especially when those decisions relate to personal wealth and financial stability.

Many investment professionals agree that managing client emotions requires as much time and energy as managing the investments themselves. Particularly challenging is the struggle to keep clients focused on long-term investment goals, especially amid the distractions of short-term market events.

Figure 1 illustrates the impact of an investor's decisions based on fear and greed. Those who stayed invested in US stocks through both the bull market of the late 1990s and the bear market of early 2000–2003 would have participated in a nearly 124% growth in wealth. On the other hand, those who tried to time the market through either fear or greed—and inadvertently missed the five-best-performing months of US equity performance—would have seen their wealth grow only as much as the growth rate of T-bills.

Investors who realize gains too early (thinking the investment might go down) or hold on to “losers” for too long in the hope that they will come back, fall victim to the fear of losing money. Greed, on the other hand, results in investor overconfidence, with “winners” being held for too long. While market timing between 1997 and 2006 is a natural example of the impact of fear and greed, the recent performance of any sector, asset class, or product is just as likely to elicit an emotional investment decision.

Fear and greed are symptomatic of an incomplete perspective on risk. While fear is the result of overestimating risk, greed is a product of underestimating it. Overestimating and underestimating risk are both bad and result in the wrong investment decisions being made at the wrong times. This in turn impacts the breadth of the asset allocation, the quality of the investment selection, and the discipline of rebalancing—all key influences on the overall risk management strategy of the portfolio.

**Figure 1: Hypothetical growth of \$10,000**

Sources: BlackRock,<sup>®</sup> Barclays Capital and S&P. The 10-best-performing months (in descending order) are March 2000, October 2002, April 2003, October 1998, July 1997, April 2001, November 2001, February 1998, September 1998 and October 1999.

Performance of stocks captured by the S&P 500.<sup>®</sup> Performance of 3-month T-bills captured by the Barclays Capital U.S. Treasury 3-month Bellwether Index.

## Three steps to managing risk

Individual investors are not alone in letting emotions drive investment decisions. Even the most experienced and sophisticated institutional investors can be held hostage to quarterly performance reviews. However, their fiduciary process demands that they lean on risk management, in part, to help mitigate the impact of those emotions. Risk management is the standard of care for pension portfolios operating under ERISA. In addition, as more states continue to ratify the Uniform Prudent Investor Act, it is rapidly becoming part of the standard of care for trust portfolios nationwide.

Whether they can articulate it or not, all investors have a risk budget—they place a limit on the amount of uncertainty or loss they are willing to tolerate in the pursuit of return. If an investor believes strongly in the goals they have set at the inception of an investment plan, risk management is the tool that helps ensure that those goals can be met. Managing risk is therefore a critical component of investment consulting.

Risk management centers around articulating how investment decisions are made and the thought process behind them. Peter Bernstein, a popular industry speaker and author of several bestselling finance books including one focused entirely on the history of risk, said, “Risk management is not about measurement at all...what matters in thinking about risk is the quality of the decisions we make in the face of uncertainty.”<sup>1</sup>

1. Peter L. Bernstein, *Risk: The Hottest Four-Letter Word in Financial Markets*, Global Perspectives on Investment Management: Learning from the Leaders, edited by Rodney N. Sullivan, CFA, 215-221 (CFA Institute, 2006).

A typical investment process includes three general stages: designing the investment plan and asset allocation, selecting investments to fulfill that investment plan, and rebalancing. Ensuring that investors remain on track to meet their goals requires evaluating and managing risk at each of these stages. Despite having a budget for risk, the average investor makes investment decisions without a full appreciation for how to spend that risk budget most effectively.

## Managing risk through asset allocation

Numerous studies have highlighted the importance of asset allocation as the primary driver of a portfolio's volatility. The right mix of asset classes maps a client's wealth goals into an actionable investment strategy, balancing total portfolio return against total portfolio risk. By diversifying a portfolio across a variety of return opportunities—across asset classes, geographies, sectors and styles—the impact of any single asset class may be minimized.

The average investor is aware of the need to allocate among stocks and bonds, and perhaps even international securities. Today's investment universe, however, extends into previously inaccessible markets such as commodities, emerging markets and real estate. Many of the world's largest investors include these areas as strategic risk management tools in their portfolios. Without understanding the risk-return characteristics of these asset classes, investors may either discount the risk management benefit they offer and avoid the asset class, or overemphasize the return benefit and overweight the asset class. As a result, creating truly diverse portfolios that maximize return for a given level of risk could be out of reach for the average unadvised investor.

## Managing risk through investment selection

An asset allocation represents a target investment strategy. With tens of thousands of investment options spanning individual securities and packaged products, selecting appropriate investments to fulfill that target can be challenging.

Index investments that seek to track the performance of the asset allocation benchmarks allow for the closest tracking to the investment plan's target. On the other hand, actively managed funds and individual securities offer opportunities for returns beyond the benchmark, often referred to as alpha. By taking bets away from the asset class targets, they also introduce active risk, or the risk that those investments may perform differently than their targets.

Active risk adds a new kind of risk to the total portfolio—the possibility that the performance of the investments themselves will diverge from the strategy. Over several periods, if investments are not selected carefully and if active risk is not managed, it can mean that the investor is far from their goals.

Managing active risk requires evaluating each investment opportunity at two levels—in isolation and at the total portfolio level. In isolation, questions might include:

- ▶ How good is the manager of the portfolio at outperforming the asset class benchmark?
- ▶ Have the returns of the strategy been consistent?
- ▶ Have they been true to their style (and therefore true to the asset allocation strategy)?

At the total portfolio level, questions might include:

- ▶ How much additional risk does the strategy introduce into the total portfolio?
- ▶ Does the strategy take the portfolio away from the target asset allocation?

This two-step process is identical to one for building a portfolio of securities—first identifying good investments, and second, combining those securities to build a portfolio diversified across sectors and styles. Just as the average investor struggled to build diverse portfolios of stocks in the late 1990s, many struggle now to build a diverse portfolio of investments or managers that remains true to their asset allocation.

## Managing risk through rebalancing

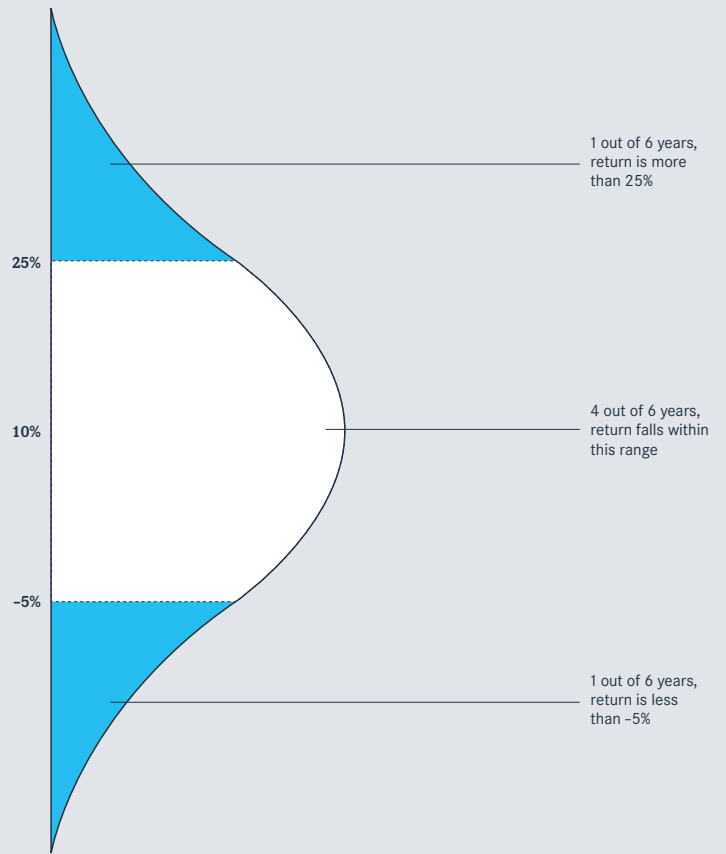
Once investments have been identified and the portfolio has been built, the investor must periodically review and adjust their portfolio to stay on track with their goals. Without rebalancing, an investor's portfolio may drift far from its target asset allocation, perhaps skewing toward a recently successful asset class. With this drift comes the likelihood that the investor's outcome will be far from their goals. Rebalancing requires focusing on risk instead of return. While all investors strive to heed the adage “buy low, sell high,” few maintain the discipline to “sell high, buy low.”

## Measuring risk

Even if they are never communicated to clients, traditional risk measures—such as standard deviation—help translate an investor’s attitude toward possible losses or gains into something quantifiable and measurable for designing and constructing portfolios. Standard deviation in particular answers the question, “On average, how widely distributed are an investment’s returns?” The larger the standard deviation, the more uncertainty (on both the upside and downside) there is around an investment’s performance. Figure 2 illustrates the distribution of possible returns for an investment with a standard deviation of 15% and an annualized return of 10%.

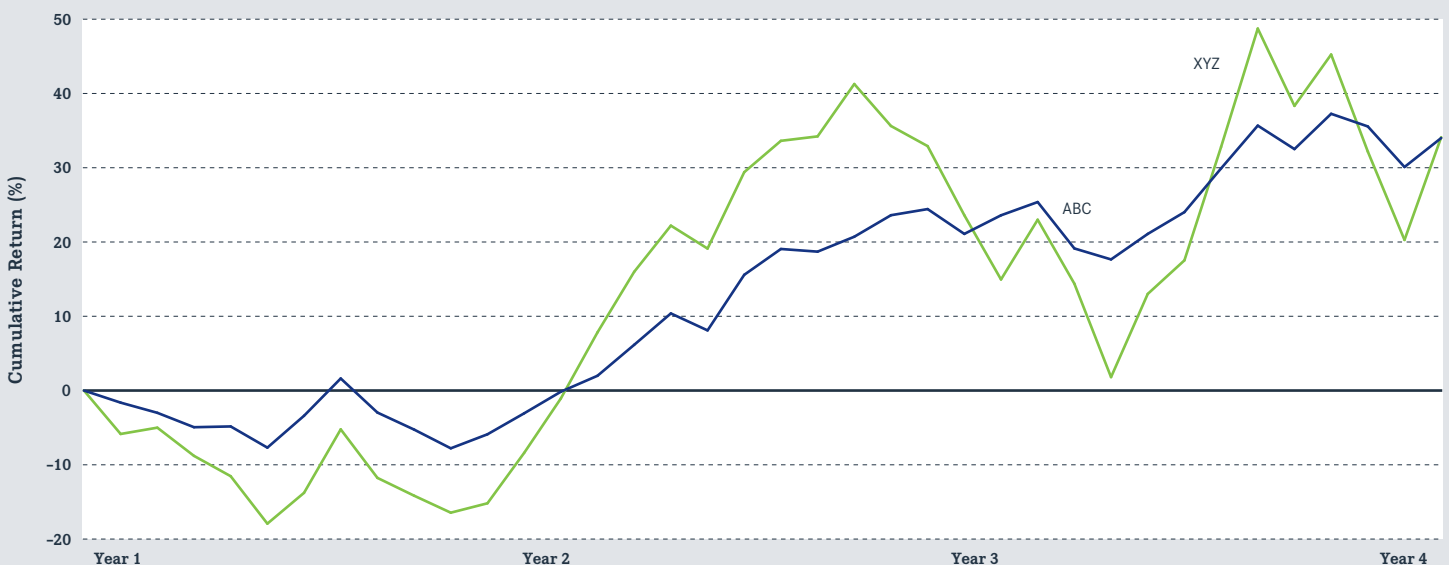
Standard deviation is also essential to evaluating whether an investment is efficient. Suppose two investments, ABC and XYZ, have each historically provided a return of 10%. While ABC delivered that return with swings that ranged between -5% to 15% in a given year, XYZ swung between -20% and 20% in any year. Rational investors would prefer the efficiency of ABC, achieving the same level of return as XYZ, but with less uncertainty (see Figure 3).

**Figure 2: Hypothetical distribution of returns**



For illustrative purposes only.

**Figure 3: Hypothetical risk/return of two investments**



For illustrative purposes only.

## The value of professional guidance

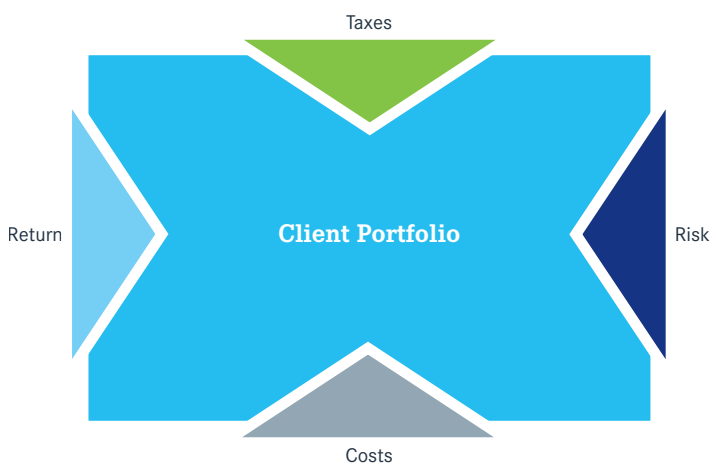
Managing a total portfolio investment strategy requires balancing four competing forces: return, risk, costs and taxes (see Figure 4). The average investor struggles to keep all four in balance, driven by emotions such as fear and greed to focus on the influences that have a direct and measurable impact on their wealth. As a result, return and taxes—and on occasion, costs—earn the most attention. The risk associated with an investment decision is either incompletely evaluated or missing altogether, despite a general understanding that risk must be endured in order to earn return.

Examining risk at the total portfolio level is particularly critical because it represents the likelihood that an investment strategy will fall short of its goal—or worse, that an investor will outlive their wealth. Managing the risk of that shortfall requires risk management at each stage of the investment process, and not simply at the initial stage of strategy development or investment evaluation.

Risk management is a framework that average investors, on their own, struggle to put in place. Without the lens of a disciplined risk management process, clients are held hostage to evaluating investment decisions from an emotional and possibly irrational perspective. Financial professionals can help investors navigate through these emotions and focus instead on the entire investment experience. Making a clear distinction between how each type of risk is being managed—through asset allocation, investment selection and rebalancing—reinforces an investment professional's foundation on process, experience and knowledge.

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**Figure 4: Total portfolio management**





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