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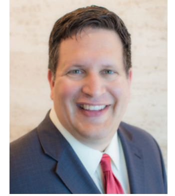
7 Key Concepts for Helping Investors



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#1

Intrinsic Value

The fundamental value of a stock or market based upon price relative to earnings, dividends, sales, or cash flow, without regard to the market value or the current price.

#2

Systematic Risk vs. Nonsystematic Risk

Systematic risk is the risk of the entire stock market, bond market, or the economy. Systematic risk can be affected by both domestic and global changes in interest rates, GDP, corporate earnings, oil prices, geopolitical events, inflation, unemployment and other factors. Systematic risk is often referred to as *non-diversifiable risk.* The practice of *asset allocation,* or an investor dividing up his or her assets among stocks, bonds, and cash for the purpose of reducing risk and optimizing return for a particular risk tolerance, can assist in mitigating systematic risk.

Nonsystematic risk is often referred to as single stock risk or single security risk and it can be substantially diversified away by purchasing several securities. Often even the most focused portfolio managers will own 20 to 60 individual stocks in their managed stock portfolio to substantially reduce nonsystematic risk.

Asset allocation cannot guarantee a profit or eliminate the risk of fluctuating prices and uncertain returns.

#3

Standard Deviation

Standard deviation is the barometer for risk in the investment world, measuring the volatility of returns around the average, for returns of stocks, bonds, and other securities. Portfolios with a relatively low standard deviation may have a higher probability of producing future returns that are closer to historical averages. For investors living off of their investments in retirement, a portfolio with a high standard deviation may be detrimental during a significant market drawdown, potentially causing an investor a substantial loss of principal and increasing the risk of an investor running out of money during retirement.

#4

Non-correlation

It is important to invest in asset classes that have a low correlation to each other, in order to reduce overall portfolio risk and improve returns as well.

Example:

Both foreign bonds as well as municipal bonds often exhibit low correlation to U.S. common stocks.

Stocks offer long-term growth potential, but may fluctuate more and provide less current income than other investments. An investment in the stock market should be made with an understanding of the risks associated with common stocks, including market fluctuations.

Investing in foreign securities presents certain risks not associated with domestic investments, such as currency fluctuation, political and economic instability, and different accounting standards. This may result in greater price volatility.

Investing in fixed income securities involves certain risks such as market risk if sold prior to maturity and credit risk. All fixed income investments may be worth less than original cost upon redemption or maturity. Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can result in the decline of the value of your investment.

#5

Real Rate of Return

Real return refers to the return an investor receives after inflation is taken into account.

Example:

Assume the national average for a one-year certificate of deposit or CD is 0.48% and assume that inflation is 1.5%. The real return on average for investors purchasing one-year CDs is -1.02%, or a 1.02% loss of purchasing power once inflation is taken into account.

Often investors will measure *real return* after inflation and taxes as well to arrive at a more meaningful definition of return.

#6

Counterintuitive Rebalancing

The technique of *counterintuitive rebalancing* by investors is to buy during periods of market distress when prices are less expensive and sell during periods of euphoria when prices are less attractive.

#7

Retirement Income Portfolio or Yield-Based Portfolio

A yield-based portfolio focuses on income and matching up required cash flows earmarked for retirement with portfolio cash flows of stock, bond, and potentially annuity income, with the idea of not running out of money in retirement. It may prove helpful from a behavioral finance standpoint by changing an investor's focus from, "What is my short-term performance this month or this year?" to "I can focus on taking my income to cover my needs and leave my principal intact to adjust with changes in the stock and bond markets."

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