TOTAL RETURN

# Forget Fear

A new way to look at the classic tradeoff between investing risk and reward

IN 2010 THE STOCK MARKET FINISHED ITS SECOND ABOVE-average year in a row. By year's end, the S&P 500 Index had gained 93% from the March 9, 2009 market low. Clearly, we've witnessed a strong rebound after a very difficult financial crisis. And yet, in my meetings with investors of all kinds, the issue of risk is front and center. In many ways, this is a natural reaction to the market's 2008 free-fall. However, I'd like to offer **BLACK ENTERPRISE**'s audience another perspective.

How often have you heard that the stock market is "like a roller coaster?" In some ways, the comparison is perfect and obvious. The market's precipitous fall in 2008 was followed by a dramatic rise in 2009 and then another increase, though less spectacular, in 2010. Many investors would easily liken the journey to a hair-raising ride—although less fun than the ones in amusement parks. And there's no question that the volatility of the market has been augmented in the past few years—the hills it has climbed have been steeper and so too have the descents. This instability has led to risk-aversion. Risk has subsequently become a four-letter word—the kind you don't want to say in mixed company. But here's where the roller coaster analogy does not connect. For most riders, the roller coaster is scariest at the top and somewhat calming at the bottom. Yet, during market swings, investors feel reassured and enthusiastic when stocks are popular and expensive, scared and running for the exit when they bottom out.

As *Barron's* so aptly noted in quoting a Wall Street market strategist, "investors 'will go to great pains to avoid repeating the most recently made mistakes. Today, this shows up as investors' extrapolating of the historically highest volatility' of 2008 into [the future]." As a result of this flawed reasoning, perceived safe havens have reigned supreme as evidenced by huge flows into bonds, gold, U.S. Treasury bills, and hedge funds. I put emphasis on perceived safety because such large asset flows have at the same time inflated values and inadvertently amplified risk.

Of course, this generals-fighting-the-last-war movie has run many times before. The name for it is risk homeostasis. The idea being, if you believe conditions are less risky, you'll take more risk. If conditions seem more risky, you'll take less risk. The problem here is that investors typically sense less risk when the market is flying (which is in fact a riskier time to buy). Conversely, there is a perception of more risk when stocks are cheapest.

So these déjà-vu moves have left investors missing big gains in the stock market since its March 9, 2009 low.

I won't promise that you'll be perfectly comfortable watching your retirement account balance drop sharply during a stock market downturn. But there are three steps you can take to stay the course.

First, develop an asset allocation plan that balances your own personal risk tolerance with your goals. Both Morningstar and the Vanguard Group have excellent tools to help you create a plan. I have my own personal recommendations, too. In your middle years, strive for a 60% to 80% stock weighting, a 20% to 40% bond stake, and keep cash below 10%. As you near retirement, pare back to 40% to 60% stocks, balanced with 40% to 60% bonds, and cash between 10% and 20%.

Second, resolve to stick to your plan and hold stocks, especially during a downturn. Finally, dollar-cost-averaging does a world of good. When you contribute automatically to a 401(k) plan, 403(b) plan, or IRA, you will avoid loading up too much when stocks are at their most expensive, and you automatically keep buying while stocks are cheap.

**—Mellody Hobson**

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Mellody Hobson is president of Ariel Investments L.L.C., a Chicago-based money management firm that serves individual investors and retirement plans through its no-load mutual funds. She is also a regular contributor to ABC's *Good Morning America.*