The Risk vs. Return Tradeoff

By Steve Gilbertson, CFP®

For many investors, the term "risk" is seen as a negative, because to them, "risk" simply means the possibility for losses. While it is true that risk does imply the possibility of losses, it also means "opportunity," because when investing in the financial markets, without the risk of losses, you have very little chance of achieving significant investment returns. This idea of having to take on risk to achieve significant returns is known as the "Risk vs. Return Tradeoff."

The basic premise of the risk vs. return tradeoff is rooted in the fact that no one likes to lose money, and in order for investors to be willing to invest their assets in riskier investments, they need to receive in exchange the opportunity for greater investment returns. Without this possibility for higher returns, in the financial markets driven by supply and demand, no one would want to invest in riskier assets. These laws of supply and demand, then, dictate that riskier investments generally have high potential rates of return while less risky assets offer substantially lower potential returns.

Consider the example of stock and bond securities. Within the stock market, small cap stocks tend to be riskier than large cap stocks. Within the bond market, corporate bonds tend to be riskier than government bonds. Following the logic of the risk vs. return tradeoff, then, we should expect that, over time, the riskier assets will outperform the less risky assets. This concept is illustrated by the historical returns of four common asset classes over the past ten years (through 3/31/06), listed from most risky to least risky:

- **Small cap stock[*] – 10.15%**
- **Large cap stocks[*] – 8.95%**
- **Corporate bonds[*] – 6.31%**
- **Government bonds[*] – 5.54%**

Over the past 10 years, then, these asset classes have followed the expected pattern of higher-risk assets achieving greater returns. While not always the case, this risk vs. return tradeoff has very often historically proven true over the long term.

Applying this concept of the risk vs. return tradeoff to your investment selection, understand that, while there are strategies that you can use to maximize your returns for a given level of risk (such as having a well-diversified portfolio), if you want to give yourself a chance of achieving above-average investment returns, you are likely going to have to take on above-average risk levels. If you are only willing to take on a very limited amount of risk in investing, realize that you are significantly limiting the level of investment returns that you can achieve and you will need to adjust your expectations accordingly.

What's essential, then, is finding a balance of risk and return with which you are comfortable. A good place to start is by completing the risk tolerance questionnaire found in "Evaluating Your Risk Tolerance," a prior "Goals and Dollars" article. Once you have determined your risk tolerance, the next step is developing and instituting a diversified portfolio designed to meet this level of risk. Keeping in mind the concept of the risk vs. return tradeoff, your investment return expectations should be adjusted to be commensurate with this level of risk.

If you have any questions about this topic, please contact Steve Gilbertson, CFP® at The Bryton Companies at sgilbertson@bryton.com, 515.223.9301.

[*] Source: Thomson Financial, April 2006. Benchmark Indexes used are as follows: Large-Cap stocks – S & P 500 Index, Small-Cap Stocks – Russell 2000 Index, Corporate Bonds – LB Government/Corp. Bond Index, Government Bonds – LB Intermediate Government Bond Index. Past performance is no guarantee of future results.