# Why 'Safe Harbors' Can Be Risky Business

# Why 'Safe Harbors' Can Be Risky Business

We see it often: Whenever investors are spooked by turbulent times, dollars tend to flow out of the stock market and into "safe harbor" investments such as bonds, bond funds, CDs, money markets, or even cash.

For example, while the S&P 500 was up nearly 25% for the year as of mid-November, an October 2019 CNBC article reported that $322 billion had recently flowed into money market funds "at the highest rate since the financial crisis." The author suggested, "Facing a constant drumbeat of headline risk, investors have headed to the mattresses as a way [to] protect cash until the storms clear."

As part of your overall investment strategy, it usually makes sense to allocate some of your wealth to safe harbor holdings. But too much "safety" can actually put your wealth at risk. Today, we'll explore why.

## *The Ups and Downs of Volatility Risk*

Even in calmer times, we tend to think of fixed income as "safer" and equities or stocks as "riskier." These labels are relatively accurate … if we're talking about volatility. That is, even if an investment grows over time, how wildly will its price swing up and down along the way?

**Fixed income is less volatile.** A high-quality bond or similar holding priced at $100 today will probably be priced around the same a year from now, give or take a few dollars.

**Equity is more volatile.** In contrast, it's much closer to anybody's guess what an individual stock might be trading for a year from now. You might catch a wave and see your investment surge. But your holding could also be worth considerably less or even become worthless.

As such, it's usually wise to protect against volatility risk for the assets you'll need for the next one to five years or so. But make no mistake about what you're also doing when you seek a safe harbor: *By protecting a holding from losing much in value, you're also effectively eliminating the chance it will gain much either.*

In other words, volatility contains both upside opportunities and downside risks. As such, a safe harbor is only partially safe—because volatility risk is not the only risk around. In fact, we would argue long-term investors face an even greater one: inflation.

## *Volatility Fades*

Again, it's important to prepare for upcoming spending goals by protecting against volatility. What if you've got college costs, or a home purchase, or similar expenses looming? If a bear market happens to roar in at just the wrong time, you don't want downward volatility to eat into the assets you're depending on for these near-term needs.

On the other hand, volatility risk is far less of a concern for distant spending plans. It's largely expected to fade when viewed across longer timeframes. Here's a helpful analogy for comparing the stock market's expected long-term growth versus its near-term volatility:

> **"It's like a man walking up a big hill with a yo-yo and keeping his eyes fixed on the yo-yo instead of the hill."**
>
> ALAN ABELSON

*The Behavioral Investor* author Daniel Crosby provides a more empirical illustration: "Greg Davies shows that if you check your [stock] account daily, you'll experience a loss just over 41% of the time. … Look once every five years and you would have only experienced a loss about 12% of the time and those peeking every 12 years would never have seen a loss."

If you have the time (and emotional stamina) to tolerate the market's volatility's risks, you can expect to benefit from its uphill climb. In contrast, reacting to a volatile "yo-yo" is only expected to distract you from your financial journey. This is important, because market growth is essential to combating the other risk we've mentioned: the insidious impact of inflation.

## *Inflation is Forever*

Why do we save and invest? You SAVE money you don't need today for future spending. You INVEST some of your savings to maintain, if not strengthen, your reserves. Typically, the goal is to maintain, if not improve, on your lifestyle.

Why not just sit in cash or its equivalent? After all, if you stash $100 in a sturdy lock box, it's highly likely to stay there. Even decades from now, it should still have a $100 face value.

But there's a catch. Inflation virtually guarantees that this same $100 won't buy you as much in the future. According to this handy Consumer Price Index calculator, a $100 purchase made 20 years ago would now set you back about $153.

A degree of inflation is actually built into a healthy economy. For example, the U.S. Federal Reserve targets an annual inflation rate of around 2% to achieve price stability. That's why it's usually wise to invest savings you won't need for a while—and keep them invested. The more you allocate to "safe" investments, the more likely inflation will diminish your spending power. The more you allocate to low-cost, globally diversified index or index-like stock funds, the more effectively you can combat inflation risk—*if you ignore the yo-yo throughout the journey*.

How do you determine the right balance between safe-harbor holdings vs. sources of expected return? As important, once you've got an appropriate investment portfolio in place, how can you minimize the temptation to react to scary market news?

By no coincidence, both of these queries are exactly what we're here for. We are guided by the evidence, and dedicated to serving your highest financial interests in a fiduciary relationship.

Please let us know if we can tell you more.

Jared Siegel | 503.974.5737
jsiegel@delapwa.com
delapwa.com