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Talking to your clients about risk

Use visual tools to show the effects of time horizon on real returns

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Among the most important types of guidance good financial advisors offer is in helping their clients make the trade-off between risk and return that is right for them.

Another form of guidance is in helping your clients understand the critical impact that the length of time they hold investments has on the degree of volatility those investments experience. And here's where you need to have that conversation about the impact of time frame.

You could start by reminding your clients of after-inflation returns for different investments for the 84 years from 1926 (as far back as we have really good data) to the end of 2009.

For example, consider average real return on $100,000, compounded over 20 years — in today's dollars:

> U.S. large-cap stocks gained an average of 6.6%, for $359,041;

> five-year U.S. government bonds gained 2.26%, for a real return of $156,356;

> T-bills gained 0.64%, for a return of $113,609.

That's the first step.

Even though most clients have heard the following statement before, it’s still worth reminding them: stocks enjoy a pronounced advantage over bonds and cash after inflation is taken into account — even after the 2008 meltdown.

Next, use different holding periods to show what happens to the chances of losing money after inflation.

Over the past 84 years, a client invested in U.S. large-cap stocks — with a holding period of one year — had, on average, a 68% chance of making real-return gains. That’s because there were 57 winning years and 27 losing years over that period.

Similarly, a client with a 10-year holding period stood an 88% chance of making real gains. A 20-year holding period meant a 100% chance of winning.

As a side note, when you look at five-year U.S. government bonds, the chances of losing money in one-year periods after inflation is actually greater than in stocks. (Granted, when you lose money in stocks, the magnitude of the drop tends to be much greater.) Over that same 84-year period, U.S. government intermediate-term bonds had 51 one-year winning periods and 33 one-year losing periods. So, they made money 61% of the time.

> Translating Returns Into The Investor Experience

While it may be interesting to show the chances of losing money in stocks depending on holding periods, that exercise doesn’t really portray the nature of the experience in a way that investors can relate to.

To do that, we converted data from Morningstar Research Inc. ’s Encorr database using the Ibbotson SBBI large company stock index into a number of charts.

The topmost chart above, which shows one-year returns, has extreme spikes. If this was all that investing in stocks entailed, most investors would bail out right there.

As we increase the number of years, the volatility gradually decreases. By the time you get to 10 years, you see a level of volatility that is still more than many clients would like, but it's at a level that most can live with.

You could go on to show these charts for 15 and 20 years, which would show volatility at progressively lower levels, but you risk losing buy-in from clients for whom thinking even 10 years out is a stretch.

> A Useful Conversation About Risk

When talking to your clients, start off by reminding them that over the long run and after inflation, U.S. stocks have earned more than 6% annually — even after the disastrous stock market events of 2008 and early 2009.

Go on to say: "The downside is that if you invest in stocks, we know that you'll lose money in about three in 10 years, and periodically you will lose more than 20% in a calendar year."

Notice that you don't say, "You might lose 20%"; you say, "You will lose 20%."

You could go on to say: "And, twice, these 20% declines occurred two years in a row. We know this because in the 84 years since 1926, stocks have lost 20% or more eight times after inflation — so about one in 10 years. Three of those drops were in the 1930s. Then, it happened in 1946, in 1973 and 1974, and, most recently, in 2002 and 2008."

Then, show your client the one-year returns chart and spend some time talking about it.

Continue on: "The good news is that the longer your holding period, the less you have to worry about this. The extreme ups and downs disappear and the tops and the bottoms on returns get cut off."

When you’ve finished, you can have a useful conversation with clients about what their ideal time frame is, their risk tolerance and what it takes for them to sleep at night.

> The Elements Of Clear Communication

Your objective in talking to clients should be to explain things in a way that is not just persuasive and easy to understand but also to communicate in a way that they’ll remember.

To do that, you have to connect at both a rational and an emotional level. Only by making an emotional connection will you make your message really stick.

In order to make your message penetrate, find your own set of words to show that for clients with a time frame of 10 years or more, history truly is on their side.

Consider using charts such as these to back that story up. Pictures truly do communicate in a way that words or numbers alone never will.

The time you spend to craft and deliver this message could be one of the better investments you’ll make.

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