Understanding Risk
To Help You Invest Soundly
Part II

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Don’t forget disclosure!
Section 2 - Risk With Investing In Capital Markets

- Risks with Bonds
- Risks with Stocks
- Risks with Investment Companies
- Investment Risk

Risks with Bonds

Buying and Holding (income generating)
- If bonds are bought and held until maturity you know exactly what your ROI will be.

Trading Bonds (speculative)
- The market value of a bond is affected by changes in interest rates. As the maturity date approaches the market value will approach the face value of the bond.
Taming Inflation and Interest Rates

http://research.stlouisfed.org/fred2/

- Default Risk - risk of the company becoming insolvent i.e. unable to pay debts.
  - Note: only corporate issued debt
- Interest Rate Risk - comes from interest rates moving up rendering your bond less valuable.
- Reinvestment Rate Risk - When bonds pay coupons those coupon payments might need to be reinvested. If rates have dropped then they will be reinvested at a lower rate than the coupon rate.
- Options - Callable options give the issuing company the right to pay you back your principal and call the bond.
**Default Risk**

**Q:** If a company defaults where are we in line?

**Ans:** Behind bankers, ahead of preferred and common shareholders.

**Q:** In case of default what of my principal would I get back?

**Ans:** Depends on many factors. Assets the company has. Will they rise out of bankruptcy? Will someone with deep pockets step in and rescue the company?

**Q:** How can we gauge Default Risk?

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**Rating Agencies**

<table>
<thead>
<tr>
<th>Moody's</th>
<th>Standard &amp; Poor's</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aaa</td>
<td>AAA</td>
</tr>
<tr>
<td>Aa</td>
<td>AA</td>
</tr>
<tr>
<td>A</td>
<td>A</td>
</tr>
<tr>
<td>Baa</td>
<td>BBB</td>
</tr>
<tr>
<td>Ba</td>
<td>BB</td>
</tr>
<tr>
<td>B</td>
<td>B</td>
</tr>
<tr>
<td>Caa</td>
<td>CCC</td>
</tr>
<tr>
<td>Ca</td>
<td>CC</td>
</tr>
</tbody>
</table>

Investment Grade: Junk

<table>
<thead>
<tr>
<th>Rating</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aaa</td>
<td>The obligor's capacity to meet its financial commitment on the obligation is extremely strong.</td>
</tr>
<tr>
<td>Aa</td>
<td>The obligor's capacity to meet its financial commitment on the obligation is very strong.</td>
</tr>
<tr>
<td>A</td>
<td>An obligation rated 'A' is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than obligations in higher-rated categories. However, the obligor's capacity to meet its financial commitment on the obligation is still strong.</td>
</tr>
<tr>
<td>Baa</td>
<td>An obligation rated 'BBB' exhibits adequate protection parameters. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitment on the obligation.</td>
</tr>
<tr>
<td>Ba</td>
<td>Predominantly considered speculative with regards to paying interest and capacity to repay principal. Considered junk bonds.</td>
</tr>
</tbody>
</table>

**Q:** What’s the risk worth?

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Price of Default Risk


https://personal.vanguard.com/us/funds/bonds/bondyields

Interest Rate Risk or Price Risk

Today
You buy this bond…
Value: $1000
Rating: AAA
Maturity: 2 Years
Coupon: 5%

Next Day
Treasury rates increase…
Corporations have to pay higher returns on their new bonds to attract buyers…
So this bond in available in the market…
Value: $1000
Rating: AAA
Maturity: 2 Years
Coupon: 6%

Q: How much can we sell our bond for?
Ans: We have to sell it for less so that it has an equivalent value to the new bond.

Q: How can we measure Interest Rate Risk?
Bond Duration

A bond’s Duration - tells us the percentage change in the price of the bond, that we could expect, if interest rates rise or fall by 1% or 100 basis points.

Example

<table>
<thead>
<tr>
<th>Issuer</th>
<th>Rating Moody's/S&amp;P</th>
<th>Coupon Maturity</th>
<th>Dur</th>
<th>Price YTW</th>
</tr>
</thead>
<tbody>
<tr>
<td>CAPITAL ONE BANK</td>
<td>FDIC/FDIC</td>
<td>3.250 1/30/2009</td>
<td>6.97</td>
<td>100.000 3.25%</td>
</tr>
<tr>
<td>FORD MOTOR CREDIT</td>
<td>B1/B</td>
<td>7.375 10/28/2009</td>
<td>1.66</td>
<td>97.000 9.26%</td>
</tr>
<tr>
<td>INVESTORS COMMUNITY BANK</td>
<td>FDIC/FDIC</td>
<td>3.250 2/8/2011</td>
<td>2.66</td>
<td>100.000 3.25%</td>
</tr>
<tr>
<td>GOODYEAR TIRE &amp; RUBBER</td>
<td>B2/B</td>
<td>7.857 8/15/2011</td>
<td>2.96</td>
<td>102.750 6.97%</td>
</tr>
<tr>
<td>SBC COMMUNICATIONS (AT&amp;T INC)</td>
<td>A2/A</td>
<td>5.100 9/15/2014</td>
<td>5.55</td>
<td>103.310 4.52%</td>
</tr>
<tr>
<td>COMCAST CORP</td>
<td>Baa2/BBB+</td>
<td>6.500 1/15/2015</td>
<td>5.66</td>
<td>107.647 5.18%</td>
</tr>
<tr>
<td>LEHMAN BROS HLDGS</td>
<td>A2/A</td>
<td>6.750 12/28/2017</td>
<td>7.36</td>
<td>106.818 5.83%</td>
</tr>
<tr>
<td>CITIGROUP (C -Z) (PFD)</td>
<td>A1/A</td>
<td>6.950 9/15/2031 - 9/15/2006</td>
<td>8.54</td>
<td>24.250 7.29%</td>
</tr>
<tr>
<td>WACHOVIA CORP (WB -S)</td>
<td>A2/A</td>
<td>8.000 PERPETUAL - 12/15/2017</td>
<td>10.20</td>
<td>26.550 7.24%</td>
</tr>
<tr>
<td>PUBLIC STORAGE (PSA-K)</td>
<td>Baa1/BBB+</td>
<td>7.250 PERPETUAL - 8/8/2011</td>
<td>10.58</td>
<td>24.800 7.41%</td>
</tr>
<tr>
<td><strong>Total Bonds</strong></td>
<td>A3</td>
<td>6.328%</td>
<td>5.59</td>
<td>6.01 %</td>
</tr>
</tbody>
</table>

Laddering and Diversifying Bonds

Client Risk Tolerance: Moderate
TFI Calculated Credit Rating: A3
Yield to Worst (YTW): 6.01%
Effective Duration: 5.59
Average Income Per Year: $6,228
Total Cost: $102,752

*All price and yield calculations are as of 1/25/2008 and are subject to change.*
A new economic dictionary

SIR - The present economic situation requires a new terminology, borrowed from physical science. For example, sublimation: the process by which assets considered solid evaporate without first passing through a liquid phase, as in, “Oh, no. My stock in Bear Sterns just sublimated.”

JOHN BAUMEISTER
Edmonds, Washington

Bonds

**Yield to Worst** - Lower of yield to maturity and yield to call. Yield to call is calculated based on the bond being called. Call options are stated in the bond indenture.

**Effective Duration** - Average percentage change in a bond’s value (price + accrued interest) under Treasury curve shifts of +/- 100 basis points. It incorporates the effect of embedded options.
Risks with Stocks

We buy a stock for - capital appreciation i.e. in hopes that the company will be able to grow the economic value of the company at a compounded rate.

Stocks are risky - because of the risks associated with stocks we seem to require this compounded rate to be around 11% or better. Approximately 5 to 6 percentage points premium over Treasuries.

Stock prices rise on expectation - what analysts and investors expect to happen based on forecasting financial data, potential product rollouts, competitive edges, barriers to entry, etc.

### Idiosyncratic or Unique Risk
- Legal suits
- CEO leaves
- Rogue trader gets busted

Can be diversified away.

### Market Risk or Systematic Risk
- Unsuccessful marketing campaign
- Product recall
- Accounting scandal

Can’t be diversified away. Can possibly be reduced.

### Currency Risk
- Interest Rates
- Recession

When purchasing international stocks currency exchange rates can increase or decrease the effective return. Currency exchange rates tend to be long protracted cycles not necessarily in sync with other markets.
Risks with Investment Companies

Mutual Funds
- Individual stock risk - may or may not be diversified away.
- Investment officer takes another job.
- Key analyst quits.
- Internal expenses grow.
- Taxes - may be handed a capital gain without realizing a ROI.

LPs
- Illiquid - no market for LPs and in many cases there are lockup periods.
- Opaque - can’t really see what is going on under the covers and the risks that are being taken.
- Idiosyncratic Risk with Managers - even more so than with mutual funds.

Investment Risk
- Conceptually - when an end is known then volatility does not introduce risk. When an end is uncertain then volatility can fuel uncertainty.
- Typically, investment returns are not known with certainty.
- Investment risk is related to the chance or probability of earning less than expected.
- That is, the greater the chance of earning far less than the mean the greater the risk.
Risk / Return

No Risk No Return!

Remember - U.S. Treasuries are considered our risk free investment and they yield on average 5% or at least can track CPI.

Return for S&P from 1997 to 2008

Return = \( \frac{Ending\ Amount - Beginning\ Amount}{Beginning\ Amount} \) \times 100

<table>
<thead>
<tr>
<th>Date</th>
<th>Adjusted Close</th>
<th>return</th>
<th>Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/2/08</td>
<td>1378.55</td>
<td>-4.15%</td>
<td>$175.35</td>
</tr>
<tr>
<td>1/3/07</td>
<td>1438.24</td>
<td>12.36%</td>
<td>$182.94</td>
</tr>
<tr>
<td>1/3/06</td>
<td>1280.08</td>
<td>8.36%</td>
<td>$162.83</td>
</tr>
<tr>
<td>1/3/05</td>
<td>1181.27</td>
<td>4.43%</td>
<td>$150.26</td>
</tr>
<tr>
<td>1/2/04</td>
<td>1131.13</td>
<td>32.19%</td>
<td>$143.88</td>
</tr>
<tr>
<td>1/2/03</td>
<td>855.7</td>
<td>-24.29%</td>
<td>$108.85</td>
</tr>
<tr>
<td>1/2/02</td>
<td>1130.2</td>
<td>-17.26%</td>
<td>$143.76</td>
</tr>
<tr>
<td>1/2/01</td>
<td>1366.01</td>
<td>-2.04%</td>
<td>$173.76</td>
</tr>
<tr>
<td>1/3/00</td>
<td>1394.46</td>
<td>8.97%</td>
<td>$177.38</td>
</tr>
<tr>
<td>1/4/99</td>
<td>1279.64</td>
<td>30.54%</td>
<td>$162.77</td>
</tr>
<tr>
<td>1/2/98</td>
<td>980.28</td>
<td>24.69%</td>
<td>$124.69</td>
</tr>
<tr>
<td>1/2/97</td>
<td>786.16</td>
<td></td>
<td>$100.00</td>
</tr>
</tbody>
</table>

Average   6.71%
Std. Dev   18.21%
APR        5.24%
Volatility of Returns

Which stock is riskier? Why?

Key Points:

- If stock price is volatile then return is volatile.
- Stock prices are volatile when future earnings are uncertain.