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FREE LUNCH? I don't think so...

We've all seen and heard it before- the man or woman at the cocktail party bragging about all the easy money they made with a winning stock. (Of course, they never seem to tell us about all the losers in their portfolio.) Now I don't want to accuse them of lying, but rather correct them on the term 'easy money'. Risk and return are related. You cannot separate the two. High returns are possible, but they are not easy or free. Risk is the premium we pay for the possibility of a higher return.

The phrase "there ain't no such thing as a free lunch" is an idiom that has been in circulation for many years. More than likely, it originated during the 1800's when saloon owners used the "Free Lunch" as an enticement for patrons to buy alcohol in exchange for enjoying their "free" lunch. Still today marketers offer to provide a FREE service in the hopes of upselling additional products. Even though the phrase is a grammatical train wreck (it is a double negative), its meaning is clear: if something of actual value purports to be free, more than likely there is a catch.

The word FREE has psychological power since it can mislead people in thinking that something is truly without cost when, in fact, it is not. This paradox is especially true when it comes to investing.

Wall Street pundits and prognosticators notoriously preach this investment gospel of stellar returns with little or no risk. And if we are not vigilant, the temptation to buy into their alluring message becomes very strong — particularly when markets are going up at historical heights.

So, today we present two reminders around this notion that there truly is no free lunch in investing:

1) Risk and return are like Batman and Robin, Bert and Ernie, Peaches and Herb, or Frick and Frack – they go together. It is a package deal—they are inseparable. If you don't like risk, short-term CDs are safe but don't deliver the long-term inflation-beating returns of stocks. Likewise, if you're looking to grow investment capital at a rate that's significantly greater than inflation, you'll have to subject yourself to significantly more price volatility (risk) than you'll find in short-term CDs.

2) Don’t believe the hype- Modern Portfolio Theory is not dead. Modern Portfolio Theory (or MPT for short) is the Nobel Prize-winning work of Dr. Harry Markowitz. MPT explains how to combine various asset categories into an optimal portfolio for a specified amount of risk (as defined by volatility or standard deviation). In a nutshell, here’s how it works: by investing in a specific portfolio (think asset allocation) of asset classes (large stocks, small stocks, value stocks, international stocks, bonds, etc.) you increase the mathematical odds of maximizing your return for an accepted level of implied volatility. Since the various asset classes held in the portfolio tend to change in value at different rates over different time periods the diversification benefit is to lower the overall price volatility(risk). But, of course, risk NEVER goes to zero = NO FREE LUNCH!

The next time you hear FREE, your radar should go on alert and prompt you to remember the wise words of Dr. Markowitz, “A good portfolio is more than a long list of good stocks and bonds. It is a balanced whole, providing the investor with protections and opportunities with respect to a wide range of contingencies."

I hope you enjoy the rest of your summer.

Best regards,

Rich

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