THE STOCK MARKET GAME™

IN THE NEWS

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On A Bicycle Built For You

By Vincent Young

Do you remember learning how to ride a bicycle? Did you have training wheels on the side of your bicycle to help keep your balance or did you have someone run alongside you, ready to catch you if you began to buckle? Did you wear a helmet, elbow pads, and knee pads?

If you haven't learned to ride a bike yet, would you want training wheels or someone running next to you to catch you in case you lost your balance? How risky do you think it would be to learn to ride without a helmet and pads?

Risk

Risk is the possibility that you'll get hurt from something you do, like learning to ride a bike without any protection. In investing, risk refers to the possibility that the asset you've just bought will lose money instead of earning it. An asset can be a stock, bond, or mutual fund. Investors accept the risk that comes with investing because they believe that the higher the risk, the bigger the **returns**. The money you've earned on an investment is called a "return." Stocks are typically considered to provide bigger returns than bonds and mutual funds but can also be riskier.

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Risk Tolerance

Your **risk tolerance** is how comfortable you are learning to ride a bike without all the recommended protective gear and equipment. In investing it's choosing the possible high risks that accompany potential high returns of investing in stocks.

Someone with a high risk tolerance would not hesitate to hop on a bicycle for the first time and just start peddling. They might even lean back on their bicycle seat and attempt to "pop a wheelie" -- that's when the bike rider brings the front wheel up into the air while the bike is still moving! This person would also not hesitate to invest in stocks.

On the other hand, someone with a low risk tolerance might insist on a helmet, pads, and training wheels before straddling the bicycle seat and pressing a foot to the pedal. This person would most likely choose to invest in **US Treasury bonds** (often referred to as just "treasuries") over stocks because treasuries are considered one of the least risky investments. A bond is a financial loan you make to the company or government that issued it. When you buy a US treasury bond, the US government is making a promise to pay you back the money you have loaned it.

Those with moderate risk tolerance might choose a helmet but not the elbow or knee pads. They might also prefer someone to run alongside them instead of having training wheels on their bike. They are willing to risk falling over and skinning an elbow or knee for the reward of learning to ride. People with moderate risk tolerance might invest in a **mutual fund**. A mutual fund is money that is collected from willing investors and invested a selection of stocks, bonds, and other assets. It is managed by an experienced financial professional.

Risk Capacity

If risk tolerance is your willingness to fall and get hurt while learning to ride a bike, your **risk capacity** is your body's ability to heal from it. In investing, your risk capacity refers to how much money you can afford to lose. A high risk capacity means losing money on your investments will still leave you with enough money for living expenses and an emergency fund. It also means you can choose to keep your money invested with the goal of earning back the money that was lost.

The economy is cyclic, meaning it changes in a pattern that repeats. We've just entered a contraction phase (when the economy is underperforming) after one of the longest expansions (when the economy is performing well) in US history. High risk capacity investors would stay invested in stocks through a contraction in anticipation of stock prices returning to their former highs when the cycle transitions into an expansion again.

Diversification

Diversification is a strategy investors use to protect themselves from risk. They believe investing in companies from different industries will help to maintain their portfolio's value when external events cause stock prices in a single industry to fall. The stock prices in the other industries may be unaffected or even gain in value.

An industry is a group of companies that provide similar products or services. Delta Air Lines. Inc. (DAL) is in the airline industry and Zoom Video Communications, Inc (ZM) is in the telecommunications industry. A diversified portfolio might include both these industries.

If stock prices in the airline industry are falling, a portfolio holding only airline stocks would lose significantly more money than a portfolio holding both airline and telecommunications stocks. The portfolio may even earn money.

Asset Allocation

Having a diversified portfolio also means investing in different assets. In a bear market, when stock prices fall, a portfolio holding all stocks might not perform as well as a portfolio that is invested in both stocks and bonds. Bonds are less volatile than stocks (meaning their prices don't change as often or as quickly) and, in some instances, bonds even perform better than stocks in a bear market[1].

The assets in your portfolio work together to reduce your risk. Deciding how much of each asset to hold in your portfolio is called **"asset allocation."** It is usually referred to as a percentage. If you hear financial professionals talking about a "60-40 portfolio," they might be describing a portfolio that is 60% stocks and 40% bonds.

If risk is the possibility of getting hurt while learning to ride a bike or potentially losing money on an investment, asset allocation is the combination of protective gear you wear to minimize the damage of a fall. Knowing your risk tolerance and your risk capacity will help you develop the asset allocation that will work the best to get you to your saving and investing goals.

60% stocks / 40% bonds

Historical Risk/Return (1926–2018)	
Average annual return	8.6%
Best year (1933)	36.7%
Worst year (1931)	–26.6%
Years with a loss	22 of 93

This is an example of a 60-40 asset allocation (including risk/returns performance) from The Vanguard Group. Source: https://vgi.vg/2KfHgtQ

TO THINK ABOUT

1. Do you think it is possible to have a high risk tolerance but a low risk capacity? Give a real life example to explain your answer and then describe how it relates to your participation in The Stock Market Game™.

2. Apply the 50-40-10 strategy to your Stock Market Game portfolio. Let 50 be low risk investments and 10 be high risk investments. 40 would refer to moderately risky investments. Which companies, bonds, and funds would your portfolio include? Explain.

END NOTE

1. The Balance, "Learn About Bonds in a Stock Bear Market," https://bit.ly/3bUts3G