The Risk of Certainty
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By Tim Courtney

It is probably not very controversial to say that on most days we would prefer to have a good idea how that day is going to unfold. While some surprises are welcome, overall we are more comfortable with -- and value -- certainty. Markets are no different, and investments that promise certainty have no shortage of buyers. The tragic irony of these investments is that they can, if they are overused by an investor, bring about higher levels of future uncertainty.

Let’s first stipulate that as a general rule, an investor should target at least inflation as a minimum expected return on investments over their lifetime. While this rule doesn’t always apply, it does make sense that if an investor cannot earn at least the rate of inflation, they should spend their money now before inflation moves prices of goods and services higher.

But let’s also acknowledge that investors like certainty, and investments such as CDs, high quality bonds, money markets and some annuities offer the certainty of an amount of income being paid on a specific date. The problem with these investments is that while they offer certainty of cash flow, there is less certainty that they will beat inflation.

Going back to 1926, investments such as cash instruments and bonds have failed to beat inflation roughly one-third of the time (Source: Excencial Wealth Advisors). Investors, in essence, bought the certainty of cash flow but had to accept greater uncertainty in achieving real returns.

By no means are we suggesting that bonds, CDs or other similar investments do not belong in portfolios. The lesson is that an investor’s need for certainty of income should be balanced by the certainty that they will obtain real returns over time. This will allow them to produce an expected return that maintains a standard of living, purchasing power and a true sense of security. This means that most portfolios need at least some exposure to investments with less near term certainty, such as stocks.

Investors who seek absolute near-term certainty usually have to pay for that privilege through high prices and lower expected real returns. In many cases this certainty, or at least perceived certainty, ends up being just too risky.

Sources:

1) DFA Returns 2.0 Software

5000 Legacy Drive, STE 180
Plano, TX 75206
P 888-741-5508
P 888-985-7162

187-B Boston Post Road
P. O. Box 623
Old Lyme, CT 06371
P 888.434.5999

9108 N. Kelley Avenue
Oklahoma City, OK 73131
P 888.478.1971

ExencialWealth.com