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VIEWS FROM THE BRICK

COMING UP SHORT

Risk within the discussion of investing tends to mean different things to different people. Most commonly, risk is perceived as volatility in price swings. To those who are tasked with measuring and quantifying risk, it usually gets defined as the chance of significant or complete loss of capital. There's one interpretation of risk that is often forgotten that Warren Buffett brought up in his annual letter to Berkshire shareholders this month. It's one that we think everyone should spend a few minutes thinking about. It's the risk of coming up short.

WHEN RISKLESS DOESN'T MEAN RISK LESS

The 17-page annual letter is a must-read for investors all across the spectrum. Typically Warren will highlight the recent year's performance of Berkshire and the interpretation of these results as digested by him and his longtime partner, Charlie Munger. But the 2017 letter carried an important lesson and anecdote for investors that we hope they don't ever forget.

Warren notably entered a wager with the investment firm Protégé Partners in 2007. The bet pegged the hedge fund industry against an unmanaged S&P 500 index fund for a 10-year period. Warren's hypothesis was the S&P 500 index fund would outperform a group of fund of funds hedge funds selected by Protégé. The winner of the bet would have the $1M pot (split 50/50 between the two sides) donated to a charity of choice.

The turn of the calendar into 2018 brought an end to the wager, and Warren's hypothesis was proven to be true. But that's not the lesson to be taken away here, although there is one in there that we're not going to dissect at the moment. In order to reach the $1M pot by 2017, each side put up $318,250 and invested in U.S. 10-Year zero coupon bonds in 2007. The idea was, at the maturity the investment would be worth $1M in 2017 terms (a 4.56% annualized return) [1]. Sounds simple right? Put your money into a riskless asset and receive your principal and some interest at maturity.

The problem is, the rest of the market wasn't in on the wager, and conditions change within the asset class. Halfway through the holding period, the bonds appreciated in value bringing the yield to maturity on the initial investment down to 88 basis points annually. The two parties' solution? Sell the bonds in exchange for Berkshire stock[2]. The result was the charitable donation surpassed the

SOURCE: This presentation is solely for informational purposes and should not be taken as investment advice. For further information, please contact one of our investment adviser representatives. [1] Berkshire Hathaway Shareholder Letter 2017 [2] GFG investment strategies carry a position in Berkshire Hathaway stock-B through ownership of ETF vehicles.

$1M target by the end of the wager period by twofold. While it might sound reckless to move an investment intended for charity from a risk free bond to a publicly traded stock, answer this: are you willing to risk coming up short of your goals?

At a less-than1% yield for the bonds in Warren's bet for the final five years, an annual inflation rate of 1% would mean they would not have reached their objective of $1M in 2017. Just because the default risk of these risk-free U.S. debt securities is virtually non-existent, it doesn't mean there was no risk at all. It's important for investors to understand there's a difference between risk of an asset and risk of an investment.

RISK OF REGRET

Are you prepared to find out when you reach a certain period of your life that your financial plan left you a few inches short? All because the perceived risk of an asset class dictated your decision? Like we said, the definition of risk seems to be fluid for different investors. One risk that is often not made explicit in conversations is the risk of coming up short.

But one thing is certain, defining your risk profile by the allocation split among asset classes within your portfolio is not always accurate. Or reliable. It's overwhelmingly important to remember markets aren't static and your plan should continue to be revisited to make sure you're giving yourself the best probability of accomplishing what you've set out to do.