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Risky Business: Five Investment Risks of 2021

Jonathan Clements
Director of Financial Education

A Perspective on the Year for Investors

The Omicron COVID-19 variant has reminded us—at least briefly—that share prices can go down as well as up. It all started the day after Thanksgiving, when the Dow Jones Industrial Average had its worst trading session of the year, plunging more than 900 points, or 2.5%.[1]

That wake-up call perhaps wasn't such a terrible thing, especially in a year when the stock market has been remarkably placid, lulling investors into complacency and no doubt seducing some into investing more aggressively than they should.

Still, even as we're reminded that stocks can have horrible days, I'd argue that what we really need is a far more important reminder—that such short-term losses should be the least of our concerns. The fact is, investment risk takes many forms. Forget the latest twitch in the Dow industrials. Here are five far bigger risks, all of which reared their ugly heads in 2021.

Risk #1: Escalating Inflation

Who knew inflation would emerge as this year's major financial risk? After all, last year, the Consumer Price Index rose just 1.3%[2]—and, early in 2020, there was even talk of *deflation*. Yet, with the latest monthly reading, we now have inflation at a 39-year high.[3]

In truth, no matter how hot inflation is running, we should always be alert to its corrosive impact. If stocks tumble 1% today, they could easily recoup that loss tomorrow. But if we fall behind inflation by just 1% each year, the cumulative damage after 25 years would slash a dollar's spending power to just 78¢. This is the big risk that bond and cash investors face today—and the reason that even retirees should consider maintaining a healthy allocation to stocks.

Risk #2: Rising Interest Rates

With faster inflation tends to come higher interest rates and thus lower bond prices, another risk we rediscovered in 2021. After four decades of mostly falling interest rates, the room for further declines is limited, while the room for rates to rise is—theoretically

1 https://www.cnbc.com/2021/11/26/stock-futures-open-to-close-market-news.html

2 https://data.bls.gov/pdq/SurveyOutputServlet

3 https://www.bls.gov/news.release/cpi.nr0.htm

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at least—unlimited. Investors got a taste for what that feels like in 2021, with many bond funds suffering modest losses.[4]

In fact, even as stock investors gloat over their gains, this ranks as a notably rough year for bond investors. Bond prices were rocked by rising interest rates, and yet bond yields are still far below the inflation rate. But there's a silver lining: Rising interest rates can be good news for bond investors who take advantage by reinvesting their interest payments and by adding new savings, and the result should be higher long-term results.

Risk #3: Falling Stocks

While 2021 reminded us that inflation and rising interest rates are big threats to our bond holdings, we were also reminded that a lack of diversification can severely hurt our stock portfolios. The ongoing battle for dominance between growth and value stocks—which growth companies won handsomely during the past decade—has turned into a more evenly matched fight this year. Those who had banked heavily on one or the other were taken for a gut-wrenching ride in 2021. But those who owned both could look on with equanimity.

What about those who favored individual stocks and were even less diversified? If you owned 2020 favorites such as Peloton Interactive,[5] Roku,[6] Teladoc Health[7] and Zoom Video Communications,[8] it's been an unpleasant year. All sit at less than half their 52-week high.

Risk #4: Punishing Politics

This year, financial markets have also, on occasion, been rattled by politics. China's stocks have suffered steep losses in 2021, dragging down the results of broader emerging market funds. Among other developments, investors have been unnerved by the government's aggressive moves to rein in the private sector, including major tech companies like Alibaba and Tencent.[9]

Even in the U.S., investors have been whipsawed by politics, as Congress wrestles over large spending bills and potential changes to the tax code. But perhaps the biggest "political" influence on the markets is the Federal Reserve, with its twin mandates to hold down both inflation and unemployment. When the Fed focuses on inflation, bond investors are happy. When it worries more about unemployment and economic growth, stock investors are the ones who cheer.

Risk #5: Hurting Ourselves

The four risks mentioned above pale next to what I see as the biggest threat of all—the one staring at us in the mirror. As Benjamin Graham, the father of fundamental investment analysis, wrote in *The Intelligent Investor*, "The investor's chief problem—and even his worst enemy—is likely to be himself."[10]

(Continued)

4 https://investor.vanguard.com/etf/list#/etf/asset-class/month-end-returns

5 https://finance.yahoo.com/quote/PTON

6 https://finance.yahoo.com/quote/ROKU/

7 https://finance.yahoo.com/quote/TDOC

8 https://finance.yahoo.com/quote/ZM

9 https://asia.nikkei.com/Business/China-tech/China-s-tech-crackdown-widens-to-Tencent-from-Alibaba

10 https://www.kiplinger.com/article/investing/t052-c016-s002-benjamin-graham-s-timeless-advice.html

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Who can argue with that in a year when we've seen investors get caught up in the hoopla over non-fungible tokens (NFTs), special purpose acquisition companies (SPACs), cryptocurrencies and meme stocks? Such market froth may be entertaining, but investing isn't meant to be entertaining. The only excitement should come decades down the road, when we glance at our account statement and see the astonishing result of many mundane decisions over how much to save, which accounts to fund, how to allocate assets, how to diversify and when to rebalance.

Want to avoid self-inflicted investment wounds in 2022? Consider focusing on two notions: risk capacity and risk tolerance. Risk capacity is the amount of investment risk we can prudently take, given our financial situation. Risk tolerance is the amount of investment risk we can stomach, given our emotional reaction to market swings.

If we take more risk than our financial situation allows or more risk than we can truly stomach, there's a grave danger that plunging financial markets could lead us to sell stocks at just the wrong time. Want to avoid that disastrous scenario?

Here's a three-point self-preservation plan. First, we shouldn't let 2021's heady stock market results go to our heads. None of us is as smart as our recent investment gains suggest. Second, rougher financial markets almost certainly lie ahead—we just don't know when. Finally, we shouldn't go it alone. When in doubt, talk to someone. How about picking up the phone and calling your financial advisor? Your wealth manager is eager to answer your questions and ensure you're comfortable with your portfolio and financial plan.

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