Part 1

Investing

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Chapter 1

Investment Risks

Investing in stocks is an exciting, action-packed, fast-moving idea that for decades has excited many people—even those with little money to invest—with the possibility of building wealth.

It is possible to make money in stocks, but it is also possible to lose. The whole question of *risk*—exposure to losses due to a variety of causes—determines how slowly or quickly values change and which kinds of stock positions you end up taking. There are many industry sectors in the market, and each has its own risk characteristics. Some are especially sensitive to changes in interest rates, and others exist within a very specific market *cycle* of changes in profits.

risk
exposure to loss resulting from numerous market, economic, and company-specific causes.

Do you know the range of risks you face as an investor? Some people think that the sole risk they face is directly related to profitability. If you make a profit, you beat the risk; if you have a loss, you lose.

While this distinction is at the core of most investment plans, it is not the whole story. Every investor wants to earn a profit on every investment decision made. However, experienced investors also understand that it's a percentage game. You are going to have some losses along the way, and the key to succeeding is creating profits that are higher than the occasional loss, and for which the dollar amount is much greater.

Key Point

No one is able to create profits in every instance. The key to success in the market is experiencing more profits than losses.

cycle
an economic tendency for sales volume and profits to change predictably due to economic or calendar timing. Among the best-known of market cycles is that experienced in the retail trade, which goes through specific seasons of high and low sales volume based on consumer buying habits.

This chapter examines a number of different risks every investor faces. It is not simply a matter of profits versus losses, but a more complex series of conflicts between supply and demand, timing, influences in and out of the market, and the economic climate. In other words, many things affect your portfolio and add to or take away from your spectrum of risk whenever you have money in the market.

Market Risk

Most people understand the most obvious form of risk, known as *market risk*, or exposure to declining prices. This is only the first of many risks every investor faces and needs to manage.

Managing risk refers to how you structure your investments to maximize profits while minimizing the chances of losses. This requires careful selection of stocks based on sensible criteria, avoiding putting too much capital into any one stock, and continually monitoring the market to spot changing trends. It also requires that when considering any one company as a possible investment, you know what trends to examine and how to determine market risk based on the indicators you pick and track.

market risk
the risk that prices will decline, reducing the value of stocks, potentially for many months; market risk is the best-known and best-understood form of risk.

Key Point

The purpose in setting up a portfolio wisely is not in completely avoiding risk, but in deciding how to manage it.

Will the value rise or fall? Realistically, you should understand that a stock's market value may either rise or fall. As apparent as this seems, some investors assume that their entry price is the "zero" point and that prices will

rise from that level as soon as a buy trade is entered. This ignores the reality that prices can also fall. So managing market risk comes down to how well you select stocks and, equally important, how well you time the decision to buy. The better you are able to pick stocks appropriate for you and to determine when to buy *shares*, the less exposure you will have to market risk. The price changes are caused by many factors, but as a general rule, the concept of *supply and demand* determines the value of shares.

shares
part ownership of a corporation that is listed publicly. Shares are bought and sold over public exchanges. Owners of shares are entitled to receive dividends and common stock owners are allowed to vote on matters of corporate management. Shares of stock rise and fall in value every day based on the ever-changing levels of supply and demand.

Market risk is the ultimate expression of supply and demand. After you purchase shares, many changes can occur. If the demand for a company's shares is quite strong, prices will continue to rise; if demand is weak, prices might fall. When the supply and demand for shares are about equal, the price tends to stay within a narrow range. This condition, known as *consolidation*, is best described as a time of indecision. No one can tell whether buyers or sellers are in command and, as a result, it is impossible to predict whether the next price direction will be upward or downward.

Market risk is easily observed in hindsight. Everyone can see when they should have bought shares and, just as important, when they should have sold. For anyone interested in creating a long-term portfolio of profitable holdings, there are ten general guidelines for managing market risk:

1. Research a company before buying stock.
2. Look for changes after you buy shares.
3. Be aware of market cycles for the sector.
4. Know a company's position within the sector, remembering that the leader tends to outperform other companies.
5. Develop a list of criteria you consider most essential for narrowing down your choices.
6. Use past trends to predict how the future might look.
7. Give up some short-term opportunities gladly, in exchange for longer-term certainty.
8. Pick a wise plan and don't veer away from it.
9. Establish clear short-term and long-term goals and use these as guides for the decisions you make.
10. Never make a decision just because the majority is making the same decision; be a *contrarian* investor.

supply and demand
the economic forces that set prices for publicly traded stocks. When buyers want more shares than are immediately available from sellers, the excess demand drives up prices. When sellers want to sell more shares than buyers want to buy, the excess supply forces prices down. The interactive supply and demand forces are continuous.

consolidation
a period of indecision in the market, during which neither buyers nor sellers are in command. No one can determine whether prices will be driven higher or lower, so there is little or no movement during this time.

These are very preliminary suggestions that are expanded in coming chapters. However, the points above do provide you with an idea of how to pick stocks, which is at the heart of how you manage and reduce market risk.

Key Point

The more time spent in researching companies and their stocks, the better able you are to understand and manage risk.

Leverage Risk

Among the many forms of risk, *leverage risk* poses one of the greatest threats to your financial health. This is the risk that arises when investors borrow money to buy stocks.

Most people will agree that it would be foolish to mortgage a home to the hilt to free up money to enter the stock market. The same people would not think it wise to seek a bank loan or line of credit to expand their portfolio. However, many of the same people will use a brokerage firm's *margin account* without hesitation. This is a form of borrowing. The margin account can be used to double up your positions. For example, if you have $20,000 to invest, you can take up positions as high as $40,000 under the rule that you have to maintain at least one-half of value in cash and securities. The rest can be borrowed in your margin account.

Valuable Resource

To review the rules governing margin trading and margin maintenance, go to www.sec.gov/investor/pubs/margin.htm.

A margin account is a great convenience, but using it increases your risk. If you expand a $20,000 to $40,000 and it earns

25 percent, you make a $10,000 profit. On only $20,000 in the same investment, you would earn only half of that, or $5,000. So the case for using leverage with a margin account is a strong one—until you consider what happens in cases of loss.

For example, if you start out with $20,000 in cash and borrow another $20,000 on margin, what happens if the $40,000 portfolio loses 25 percent? It falls to $30,000. Two things happen right away. First, your broker will issue a *margin call*, meaning you are required to meet minimum maintenance requirements, or keep 50 percent in the form of cash and securities.

In the example, the portfolio's overall value has fallen to $30,000 but $20,000 of that was borrowed in the margin account. So your capital value has fallen to only $10,000. The broker will issue a $10,000 margin call, meaning you have to bring your $10,000 of capital up to match the amount on margin, $20,000. If you cannot come up with the amount demanded by the margin call, your broker will sell off $10,000 of your holdings to pay down the margin. This results in a portfolio worth $20,000, half cash and half on margin. The net result: You have lost money, and your $20,000 portfolio now consists of $10,000 cash and $10,000 you owe to the broker.

Key Point

The convenience of a margin account is accompanied by the very high risk of margin investing. You might double your capital or lose it, all very quickly.

The rule of thumb about borrowing money to invest applies to margin accounts as much as to any other form of borrowing. It is a great convenience and all too easy to use; but the risk is high if securities fall in value. This can occur very quickly and the risk is most severe when you are fully leveraged.

contrarian
an investor or trader who makes decisions based on analysis rather than simply following the majority, and who recognizes that the majority is wrong more often than right, so making the opposite decision often is the smart move.

leverage risk
the risk resulting from borrowing money to invest. In the case of losses, leveraged positions not only have to be paid back, but losses have to be made up as well.

margin account
an account provided to investors by their brokers, allowing them to borrow up to one-half of the value of their portfolio.

Knowledge and Experience Risk

The second kind of risk involves the combination of two things: your *knowledge and experience risk* includes your investing background as well as the collective research you have performed for yourself in the past—performing online searches and studying books, magazine articles, or annual reports.

margin call
a requirement that investors deposit additional funds to meet minimum margin requirements. If the margin call cannot be met, the broker will sell some or all of the portfolio assets.

Knowledge should be acquired from sources that make sense to you. Today, especially with so many free online organizations providing free advice, it just makes sense to verify everything you discover (see Table 1.1). Sites that are selling something may offer claims that do not hold up. For example, if a web site wants you to subscribe to a service, make sure you know what you are going to get. If you are promised the "secrets of making millions" in the market or "things Wall Street doesn't want you to know," it probably involves a get-rich-quick scheme that is not going to work.

Market knowledge is best acquired when it is based on the recognition of what is truly needed to succeed in any endeavor. Success is the result of hard work, study, and analysis, but no one should rely on the claims by others to having knowledge as an easy and fast way to get rich. No one is going to sell knowledge to you. Most of us know all of this already, but it is also easy to fall victim to amazing promises for a one-time payment.

Key Point

Never believe promises of systems that make it easy to get rich. You are never going to be able to buy fast profits. However, it is quite easy to waste your money on systems that don't work.

All of the knowledge you need is out there and it is just a matter of your deciding how to acquire it. You may ask friends and relatives who have been

TABLE 1.1 Paper trading sites

The following web sites offer free paper trading:

Site	Address
Wall Street Survivor	www.wallstreetsurvivor.com/home.aspx#1
Investopedia	http://simulator.investopedia.com/Default.aspx?viewed=1
Stock Paper Trading	www.stockpapertrading.com/
Trading Simulation	www.tradingsimulation.com/

investing for many years which books or magazines to read, which web sites to visit, and how to gain solid, lasting information. You can also read reviews of books on Amazon.com or Barnes & Noble to identify the best books based on ratings and on what readers say about the books.

Experience, it has been said, often comes from making mistakes or losing money. If that is true, then losing a lot of money is "better" experience. This does not need to be the case. In fact, you can gain experience by *paper trading* stocks before actually putting cash on the line. Paper trading is a simulation involving real-time market price movement and the selection of stocks using a fictitious fund of cash.

A word of caution: Paper trading does not involve real money so the experience you gain is going to be limited. Just as you may acquire $40,000 playing blackjack on the free Yahoo! games site, when it comes to really putting $1,000 on a single hand, most conservative people will not do it. So by the same argument, don't deceive yourself into thinking that paper trading gives you real-world experience even though the decisions you make are going to be tracked based on the real market. At some point, you are going to need actual experience, meaning actual money will have to be invested in shares of stock.

Paper trading is an excellent way of learning the mechanics of trading stocks, finding out how margin borrowing works, and managing the payment and delivery of shares once an order has been entered. However, there is no substitute for the real thing. You can learn the theory of riding a bicycle by studying user manuals and watching films, but you do not actually learn until you get on the bicycle for real. The same is true for gaining investing experience.

Key Point

Paper trading is a good way to become familiar with how the mechanics of investing work. But you can never appreciate the exposure to risk in the market until your money is on the line.

knowledge and experience risk
the combined information you have gathered through research and observation, plus past investing and related activities; together, knowledge and experience ultimately determines how you view the markets and how you approach selection of stocks.

paper trading
a system of simulated investing in which a portfolio of cash can be used to buy shares of stock based on actual value in the current stock market. However, because it is a simulation, there is no risk. The purpose of paper trading is to demonstrate to a new investor how the markets work.

The risk associated with knowledge and experience is potentially quite high. If an investor makes decisions without understanding exactly what is taking place or how prices move, then the risk exists because of a lack of knowledge and experience. So the risk of making ill-informed decisions will lead to losses. Even worse, if a lucky but ill-informed decision results in a profit, an inexperienced investor may easily decide that it makes sense to place more money at risk, leading to large losses in the second or third trade.

sector risk
a risk identified with a particular sector and its industries, derived from business cycles, market conditions, or economic changes.

Sector Risk

A "sector" is a segment of the market that is focused on one industry. Sectors include companies that share distinct product or service attributes or serve a particular market. (see Table 1.2)

The concept of *sector risk* relates to the cyclical and industrial risks each sector is vulnerable to or likely to suffer from in the event of economic conditions.

TABLE 1.2 Sectors and industries

Sector	*Industries*
Agriculture	farm and construction machinery; farm products
Banking	regional; foreign regional banks; money center banks; foreign money center banks
Basic materials	basic materials wholesale; packaging and containers; rubber and plastics
Capital goods	business equipment; industrial equipment and components; industrial electrical equipment; aerospace and defense products and services; aerospace and defense—major diversified; pollution and treatment controls; machine tools and accessories; fabrication; diversified machinery; small tools and accessories
Chemicals	specialty chemicals; chemicals—major diversified, agricultural chemicals; synthetics
Clothing	apparel stores; textile—apparel clothing; textile—apparel footwear and accessories; textile industrial
Communications conglomerates	diversified communications services; telecom services; domestic; telecom services—foreign; communications equipment; long distance carriers; wireless communications conglomerates

TABLE 1.2 (*Continued*)

Sector	*Industries*
Construction	heavy construction; residential construction; manufactured housing; general contractors; cement; lumber and wood production; building materials wholesale; general building materials
Consumer durables	home improvement stores; home furnishing stores; home furnishings and fixtures; appliances; housewares and accessories; photographic equipment and supplies; electronic equipment; jewelry stores; recreational vehicles
Consumer nondurables	food—major diversified; sporting goods stores; discount and variety stores; wholesale, other; toys and games; personal products; office supplies; cigarettes; specialty retail, other; grocery stores; department stores; sporting goods; recreational goods, other; cleaning products; paper and paper products
Credit	credit services; savings and loans
Drugs	drug stores; drugs wholesale; drug delivery; drugs—generic; drug manufacturers—major; drug manufacturers—other; drug related products
Electronics	electronics stores; diversified electronics; electronics wholesale; processing systems and products
Energy	oil and gas pipelines; oil and gas equipment and services; oil and gas drilling and exploration; major integrated oil and gas; independent oil and gas; oil and gas refining and marketing
Entertainment	toy and hobby stores; general entertainment; gaming activities; music and video stores; entertainment—diversified; resorts and casinos; movie production, theaters; restaurants
Food and beverage	food wholesale; specialty eateries; tobacco products, other; beverages—brewers; beverages—wineries and distillers; beverages—soft drinks; dairy products; processed and packaged goods; confectioners; meat products
Hardware	computer peripherals; computed based services; data storage devices; networking and communications devices; printed circuit boards; personal computers
Health care	specialized health-care services; home health care; medical practitioners; medical equipment and wholesale; medical instruments and supplies; biotechnology; health-care plans; health-care information services; medical appliances and equipment; diagnostic substances
Insurance	insurance brokers; surety and title insurance; life insurance; accident and health insurance; property and casualty insurance
Investing	closed-end fund—foreign; closed-end fund—domestic; closed-end fund—debt; diversified investments; investment brokerage—national; investment brokerage—regional; mortgage investment

(*Continued*)

TABLE 1.2 (*Continued*)

Sector	*Industries*
IT services	information and delivery services; Internet information providers; Internet service providers; Internet software and services; information technology services
Media	advertising agencies; CATV services; broadcasting—radio; broadcasting—TV; marketing services; publishing—periodicals; publishing—books; publishing—newspapers
Medical facilities	medical laboratories and research; long-term care facilities; hospitals
Metals and mining	nonmetallic mineral mining; industrial metals and minerals; aluminum; gold; copper; silver; steel and iron
Real estate	property management; real estate development; REIT—hotel and motel; REIT—office; REIT—residential; REIT; retail; REIT—health-care facilities; REIT—diversified
Services	lodging; waste management; personal services; sporting activities; business services; shipping; air delivery and freight; management services; security and protection; staffing and outsourcing; technical services; consumer services; catalog and mail order houses; education and training; research; all services, other
Software	application software; multimedia and graphics software; business software and services; technical and system software
Technology	scientific and technical instruments; semiconductor industries: equipment and material; specialized; broad line; integrated circuits; memory chips
Transportation	railroads; major airlines; regional airlines; trucking; trucks and other vehicles; auto manufacturers—major; auto dealerships; rental and leasing services; auto parts; auto parts stores; auto parts wholesale
Utilities	water; electric; gas; foreign; diversified

Sector risk comes from the natural supply and demand cycle, economic conditions and their changes, political trends and actions, and perceptions among investors about specific sectors and industries.

Political and Economic Risk

The risks associated with each sector and its industries are derived from many outside sources. Among these is *political and economic risk*, which are among the most important outside factors in assessing both the viability and value of a company, and identifying the timing of purchasing shares.

A closely related risk involves potential disruption of markets. So *disruption risk* may be a secondary fallout of either political or economic risk.

Examples of possible disruptions may include terrorist attacks that close down exchanges; power outages; catastrophic threats like pandemics, hurricanes, or flooding; or localized disruptions from labor strikes, regulatory enforcement actions, or even excessive price changes in the market. The exchanges employ stopgap measures on individual securities or even on the entire market if and when trading volatility exceeds specified levels.

political and economic risk
the risk that outside influences may affect stock valuation. Political changes, either domestic or international, may curtail activities or affect customers; economic activities may slow down production, prevent expansion, or prevent companies from hiring or retaining employees.

Key Point

In cases of extreme price declines, exchanges will temporarily halt trading in a stock or, when the whole market is affected, on all stocks.

A trading disruption occurs in a specific security by way of a temporary suspension called a *trading halt* when news announcements that are pending are likely to create an imbalance. Examples include pending mergers or acquisitions, stock split announcements, or negotiations between companies concerning major news or consolidation or sell-off of major divisions.

disruption risk
the risk that trading in stocks may be disrupted by political or economic causes, acts of war, or natural disasters.

A market-wide disruption can be put into motion automatically. The so-called *circuit breaker* is a programmed temporary suspension of all trading on exchanges due to exceptionally large price declines, or panics, threatening to create *liquidity risk* in the market. The halt may remain until the close of business for one session, or for a matter of hours only. The New York Stock Exchange (NYSE) identifies three possible circuit breakers at 10 percent, 20 percent, and 30 percent price declines.

With the disruption risk in mind, especially when it develops to prevent loss of liquidity, a threat of lost liquidity—or liquidity risk—arises unexpectedly and poses a serious threat to an otherwise smoothly operating market system.

In some markets, liquidity is quite low and poses a different kind of threat. For example, in the limited partnership market, the lack of a secondary market

for units of partnerships may mean that investors wanting to sell will have to accept a deep discount. This occurs when there is no public auction market for those units. For publicly listed shares of stock, the exchanges are usually very liquid. Any shares of stock can be efficiently and easily bought and sold at the prevailing price. This transaction can occur at any time during the trading session and a growing market in after-hours trading extends not only trading, but liquidity as well.

trading halt
the temporary suspension of trading in a particular security in anticipation of an imbalance that may be created by upcoming announcements of mergers or acquisitions, or negotiations between companies.

Inflation Risk and Tax Risk

Two forces—inflation and taxes—might not seem related but in fact, they are. And together they directly influence your investment profits. The first, *inflation risk*, is your exposure to higher prices. As inflation rises (meaning everything costs more money) your capital loses its *purchasing power*. This is a huge and eroding influence on your money. For example, to match the spending power of $100 in 1950, you would have needed $891 in 2009 just to match the purchasing power of that original $100.

circuit breaker
an automatic halt to trading in all listed securities on exchanges, triggered by exceptionally large price declines and set to last a specified number of hours or until the end of trading for the session.

Valuable Resource

To calculate the spending power of any amount between any two years, go to www.measuringworth.com/ppowerus.

The effects of inflation are serious because as it rises, you need to earn a higher level of profits just to break even and maintain purchasing power. This translates to the demand for taking higher risks as a response to inflation.

If you are so adverse to market risk that you keep your money in a safe but low-yielding account, then you lose purchasing power. For example, in 2010 inflation was averaging about 2 percent. If you put your money into a certificate of deposit yielding only 0.75 percent over three months, you lose 1.25 percent of your money in reduction of purchasing power. You need to earn at least 2 percent just to match inflation—and that is before you consider the effect of taxes on your profits.

Key Point

Inflation and taxes both reduce the value of your money; but together, they can have a severe effect on profits.

Taxes come off the top of your earnings and only make it necessary to earn higher rates of return just to meet inflation. So *tax risk* is the threat that with part of your earnings going to federal and state income taxes, the remainder, or after-tax return, will not match inflation.

The tax burden is not only federal, but has to include the state tax liability as well. When both federal and state taxes are added together, the taxable percentage can rise as high as 50 percent or more.

Valuable Resource

To find your applicable state income tax rate, go to www.taxfoundation.org/taxdata/show/228.html.

So both inflation and taxes play a part in identifying the scope of risk. To maintain after-inflation and after-tax purchasing power of your capital—without even considering a true net profit—you need to calculate the effects of both. Your *break-even rate* is the rate of return you need to make just to keep your purchasing power level.

To calculate the break-even rate, first estimate the rate of inflation you expect to experience over the next year. For this, you may refer to the federal web site for the Bureau of Labor Statistics (BLS), which calculates and publishes the Consumer Price Index (CPI), the usual measure of inflation.

Valuable Resource

To find the current rate of inflation, check the BLS web site at www.bls.gov/cpi.

liquidity risk
in the public exchanges, the possibility that high volume will curtail the availability of cash needed to complete trades in shares of stock.

inflation risk
the risk of losing purchasing power in money as a consequence of rising prices over time; for investors, inflation requires ever-higher returns on investment to offset the effects of inflation.

purchasing power
the value of money when compared between years. As inflation rises, the dollar loses its purchasing power compared to past years.

tax risk
the risk that after-tax return on investment will fall short of the return needed to preserve spending power after inflation.

The inflation rate is divided by the percentage of income remaining after you deduct the *effective tax rate* from 100. For example, if your combined federal and state tax effective tax rate is 44 percent, then the calculation involves deducting 44 percent from 100 percent; the answer is 56 percent.

When you divide the assumed inflation rate by the net percentage remaining after deducting your tax rate from 100 percent, the result is the return you need to earn to break even after inflation and taxes:

$$I \div (100 - E) = B$$

break-even rate
the rate of return needed from investing activity to absorb inflation and taxes, in order to maintain the purchasing power of investment capital.

In this formula, I is inflation; E is effective tax rate; and B is the break-even return. So if you assume a 2 percent tax rate over the coming year and your combined federal and state effective tax rate is 45 percent, your breakeven is:

$$2\% \div (100 - 44) = 3.6\%$$

This shows that you will need to earn 3.6 percent *net* on your portfolio to maintain your purchasing power. In "real" terms, earning this rate does not produce any real profits; it only maintains the value of your capital.

effective tax rate
the rate of taxes assessed on taxable income, combining both federal and state rates.

Key Point

If you earn less than your break-even rate (after inflation and taxes), you are losing money on your investments. You will have to accept higher risks just to maintain your purchasing power.

With these assumptions, that 0.75 percent certificate of deposit is not going to be enough. You are losing purchasing power every year as long as you do not make at least the break-even rate. Table 1.3 summarizes the required break-even rate at various inflation rates and for different effective tax rate levels.

The higher your tax bracket and the higher the current rate of inflation, the more difficult it becomes to break even. This is the true meaning of the combined inflation and tax risk. It may be impossible to beat inflation

TABLE 1.3 Break-even rate

Tax Rate	*1%*	*2%*	*3%*	*4%*	*5%*
14%	1.2%	2.3%	3.5%	4.7%	5.8%
16	1.2	2.4	3.6	4.8	6.0
18	1.2	2.4	3.7	4.9	6.1
20	1.3	2.5	3.8	5.0	6.3
22	1.3	2.6	3.8	5.1	6.4
24	1.3%	2.6%	3.9%	5.3%	6.6%
26	1.4	2.7	4.1	5.4	6.8
28	1.4	2.8	4.2	5.6	6.9
30	1.4	2.9	4.3	5.7	7.1
32	1.5	2.9	4.4	5.9	7.4
34	1.5%	3.0%	4.5%	6.1%	7.6%
36	1.6	3.1	4.7	6.3	7.8
38	1.6	3.2	4.8	6.5	8.1
40	1.7	3.3	5.0	6.7	8.3
42	1.7	3.4	5.2	6.9	8.6
44	1.7%	3.6%	5.4%	7.1%	8.9%
46	1.8	3.7	5.6	7.4	9.3
48	1.9	3.8	5.8	7.7	9.6
50	2.0	4.0	6.0	8.0	10.0
52	2.1	4.2	6.3	8.3	10.4

and taxes while also adhering to the market risk standards you set for yourself.

Fundamental Risk

fundamental risk
the risk that financial reports on which investors rely may not be accurate and might even mislead investors in extreme cases.

One form of risk that is not often discussed in risk terms is *fundamental risk*. This is the danger that the financial statements and reports issued by a corporation might be inaccurate and even deceptive.

Is this type of risk a serious one? In recent years, many investors have lost large amounts of capital due to intentional deception. The well-known case of Enron (among many other companies) involved not only

intentional deception, but the willing participation of what should have been an independent auditing firm.

The rules governing how the numbers get reported are complex and allow companies leeway in how to interpret and report numbers. Financial results do not have any one interpretation, unfortunately, because many estimates are involved for setting up reserves, placing value on inventory, and the timing of when transactions are "recognized" (placed onto the books). Under the accrual accounting system, all income is supposed to be recognized in the year it is earned, even though cash may not change hands until the following year. All costs and expenses are supposed to be recognized in the year incurred, even if payment is not made until the following year.

Key Point

Companies can and at times do distort their profit picture. Some distortions are legal under the accounting rules, so you need to track the trends over many years to get a grasp on the long-term growth curve.

This system is intended to ensure that the recognized revenue, costs, and expenses accurately reflect what happens each year. Because it is complex and involves estimates, it also lends itself to many liberal or aggressive decisions. Even worse, it is possible for companies to manipulate the reported outcome to make matters appear better than they are. This is what happened in Enron in the extreme.

There are many ways that companies can manipulate results, including:

- Exaggerating the current's year's revenues (reporting income that will not be earned until the following year).
- Deferring the current year's costs or expenses (setting these up as assets and then depreciating them over several years).
- Overvaluing or undervaluing inventory, bad debt reserves, and other accounting matters that have to be estimated.
- Delaying the reporting of one-time large losses.
- Changing the timing for recognition of the purchase or sale of a company or segment.

Some of these kinds of adjustments are not outright fraud but matters of interpretation. But there is a line between aggressive accounting and deception, and that line is not always easy to see in advance.

Key Point

It is very difficult to pin down the line between aggressive accounting and outright deception. It is only easy to spot in hindsight.

For investors who rely on the financial statements and earnings reports published by companies in order to make the decision to buy shares, the possibility that the basic information is not reliable is very troubling. The way to overcome this risk is to set standards for how you evaluate a company. These standards should include:

1. Check the numbers over as many as 10 years and look for consistent trends. When you cannot find those trends, investigate further.
2. Don't check only one or two indicators on the financial statements. Perform comprehensive analysis and compare trends in total rather than separately.
3. Consider the reputation of management as part of the equation of trust. Rely on management that has been around for a long time, in a company that has an impeccable reputation.
4. If something doesn't look right, don't ignore it. Rely on your instincts and question anything that looks out of line.

None of these four steps guarantees that you can always avoid fundamental risk. But as a general rule, if a company's stock is rising quickly and its revenue and profits continue to outpace the past year, a healthy degree of skepticism is in order. Outright fraud is rare, but aggressive accounting can be just as damaging even if it is legal. As long as everything continues to just get better, aggressive accounting is accepted by stockholders; but as soon as the market slows down, the more aggressively interpreted financial results tend to fall quickly as well.

lost opportunity risk
the risk that capital will be fully committed so that new investment opportunities cannot be taken, reducing future profits.

Lost Opportunity Risk

The final type of risk to be aware of is the risk that all of your capital will be tied up in positions and you will miss new opportunities as a result. The *lost opportunity risk* is a matter than virtually all investors face and have to make decisions to deal with or overcome.

This risk comes about in several ways. In its most basic form, it exists whenever available capital is limited. Even if you employ your broker's margin account, if you cannot free up capital to invest in more positions than you hold right now, it is possible that many opportunities will come and go.

Key Point

You are always going to have to pass on most opportunities. The key to profitability is spotting a good opportunity when you have cash available to seize it.

A more severe form of lost opportunity risk occurs when you sell off holdings once they become profitable, but hold onto depreciated stocks. Of course, you hope those stocks will rebound and become profitable in the future; but when you take profits, you inevitably end up with a portfolio full of stocks that have fallen in value. A solution is to match up winners and losers. For example, if two of your holdings offset each other, sell them both and free up the total to invest elsewhere. If you have a profit of $3,000 in one position and a loss of $2,500 in another, by selling them both you free up more capital and you reduce your taxable income this year by offsetting profits and losses.

Risks are best managed by setting risk-related goals. Your *risk tolerance* has to define investments that are appropriate for you based on your experience, available capital, income, and perceptions about the market.

risk tolerance
the degree of risk appropriate to each individual based on experience and knowledge, available capital, income, and willingness or unwillingness to take chances.

If you do not want to risk loss, the defining phase of setting up your portfolio should be undertaken with one eye on the double effects of inflation and taxes. Settling for an exceptionally low return to avoid risk can easily lead to losses in terms of deterioration in purchasing power. It may be necessary to create a diversified risk to overcome the break-even level, but without accepting too much risk on your entire portfolio.

The next chapter expands on the discussion of how to select appropriate investments by exploring the concept of value for long-term growth of stocks in your portfolio.