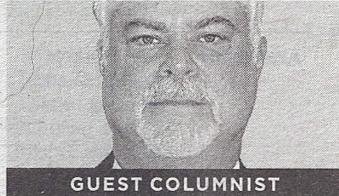
COMMENTARY | Threat of capital loss looks high now

WEIGHING MARKET RISKS, REWARDS SIGNALS 'PASS'

CALLOM B. JONES V



GUEST COLUMNIST

Investing is never just about reward. Risk is ever-present. "Getting in" gets one into both reward and risk. That may seem pathetically obvious, but you still see folks forgetting about risk as they (naturally) reach for return. Here's how it should be thought of:

- Higher reward is not an outcome of taking greater risk.
- Higher reward is what a smart investor demands for taking higher risk.

Perhaps this is best illustrated using loans, rather than equities. Say you are a loan officer in a bank. You have enough to lend to both of two candidates. One is a large, established regional firm and the other is a startup business that clearly has significant potential, but is much riskier.

A smart loan officer (who wants to remain employed) is likely to lend to the established business at somewhere between 3 and 4.5 percent above the bank's borrowing costs — the bank's prime rate or maybe a little above. That same loan officer may or may not offer funds to the startup, but if they are offered at all, they will be offered at as much as 8 percent or more above the bank's borrowing costs. More return (interest) is demanded from the riskier loan.

Another factor that should be considered when investing in this environment is the difference between opportunity loss and capital loss. Opportunity loss is the loss of potential profits from not purchasing an investment that subsequently produces returns. Capital loss is the actual loss of capital from putting capital at risk and having all or part of that risk realized. The difference? With an opportunity loss, you can still "catch the next train leaving the station." Incurring a capital loss means you need to make a return just to get back to your original position. The statistics for this can be daunting:

- A 20 percent loss requires a 25 percent gain to break even.
- A 33 percent loss requires a 50 percent gain to break even.
- A 50 percent loss requires a 100 percent gain to break even.

In a bear market, such losses require a long road back just to break even, if you can even find securities that can get you there. I tend to consistently choose the opportunity loss in a bear market.

The recent run-up in equities and commodities should make a smart investor think that perhaps the relative reward/risk relationship has changed and should be factored into any current investment thinking. We've had a HUGE run in both markets for about two years, much of which I think is unsupported by an improving economy. Therefore, there is a strong possibility markets are at or near a top.

The dividend yield on the Dow Jones industrial average is below 3 percent, far below its long-term historical average of 5 percent. This is more indicative of a market top than a continuing bull market. History also strongly suggests that the Standard and Poor's 500 is likely to be 10 percent cheaper in a year.

Should an investor "get in" now, there is a real possibility that he could make money in the short-term and then have the market correct sharply before he could determine whether it was a change in trend and get out, or a short-term move to ride out. If it was a change in trend, the likely result is that it would end up costing both profits and capital. This brings up two thoughts:

If you have profits and don't sell in time to keep them, you never really made them.

In the current market, I'd opt for the opportunity loss, as explained above.

Callom B. Jones V owns Trend Capital Management LLC, a Registered Investment Adviser in Overland Park.