Understanding the Risk-Reward Sides of Investing

By Roger Balser
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money talks

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It's April and spring is in bloom. For many of us spring means the much-awaited arrival of crocuses, green grass and, of course, the Masters golf tournament at Augusta National in Georgia. This very exclusive event represents the Holy Grail for the golf world. And where every major golf course around the world has its promoted signature hole, Augusta National boasts a signature corner consisting of not one, but three very tough — but stunning — signature holes.

"Amen Corner" was the term coined by Herbert Warren Wind in his 1958 *Sports Illustrated* article chronicling that year's tournament. It's the stretch of holes on Augusta's famed back nine that starts with a downhill second shot on the 11th hole and continues through the tee shot on the famed 13th hole. But the rest of the 13th hole is often where the Masters can be won or lost on Sunday. The first of two par-five holes on the back nine, the 13th hole — aptly named "Azalea" — is the ultimate risk-reward hole.

Famed golf course designer Robert Trent Jones called Azalea "perhaps the best short par-5 ever built." In 2002 the tee box was pushed back to lengthen the hole to 510 yards, but in today's game it's considered relatively short. There's a tributary (Rae's Creek) which runs down the left side of the hole and swings around the front of the green, providing a formidable water hazard. It's because of these hazards that the 13th is the scene of high drama every year.

In 1994, Jeff Maggert scored a double-eagle two on the 13th. Nick Faldo ended Greg Norman's bid for the Master's fabled green jacket in 1996 with a laser 2-iron shot to the green for an eagle. Tiger Woods has putted the ball off the 13th's slippery green and into the creek. And in 2010, Phil Mickelson hit one of the best shots of his career from the pine straw to within a club length of the hole. The 13th is truly a classic risk-reward hole.

But players know that to have a chance at a game-saving eagle at the 13th, a well-placed tee shot is vital to give the golfer an opportunity to even ponder an aggressive second shot at the green. A drive into the trees or the pine needles makes going for the green a shaky proposition with a low probability for success. And even with a good tee shot, the second shot is one based on pure conjecture and strategy. About half of the players will attempt to hit the green in two shots. It's quite simply a remarkable risk-reward hole that offers many options.

It's this type of risk-reward decision that investors and their advisors encounter every day. The key to repeatedly making wise investment decisions is having sound indicators. A golfer knows his distance, his lie, the wind direction and whether he needs to play aggressively or conservatively before he pulls out a club. The average investor often doesn't know what hole he is playing. Without sound indications of what current risk levels are in the marketplace, how can any advisor truly feel comfortable telling a client which club to pull out of the bag, much less which direction to swing?

When I look at the market indicators today I see the equivalent of what PGA tour professionals see at "Azalea" after they nail a good tee shot. They see a difficult second shot, but one in which there are many options and lots of opportunity. Our indicators today are telling us that we have entered a new 'structural bull market,' meaning we have a green light with respect to the U.S. equity markets, and are identifying the first step toward sound risk management. The shot in front of us is not easy; there are still risks, but we have the option to play for eagle or birdie rather than struggle for the ho-hum par.

What are the current risks? Here are just a few:

- The Federal Reserve has begun the tapering back of its stimulus program.
- The slowing of the Chinese economy.
- The mid-term elections, which breeds a high degree of uncertainty leading up to November.
- The never-ending volatility in the Middle East.

There are plenty of things that could derail this market. But simply put, we are in a wealth accumulation mode and the most important thing we can do is simply to make sure our actions are consistent with that risk status.

There will always be those investors who want to wait until everything lines up before they put their money to work in the market. They dream of opening up the *Wall Street Journal* and seeing an “All Roses” alert at the top of the front page, coupled with a U.S. economy that looks like someone put rocket fuel in its gas tank, and the heads of state in the Middle East all joining together for one big group hug.

The reality is that isn’t going to happen (and if it did, it would probably represent a market top rather than a bottom). Low-risk opportunities in equities are typically not met with “All Roses,” but rather something more similar to the view from the fairway on “Azalea” at Augusta after that perfect tee shot. A tough second shot, but one with many potential options that offer the possibility of very positive outcomes.

So you can choose to play it safe and lay-up as Zach Johnson did to win the Masters in 2007. But now is not the time to just stare at this potential market with knees knocking, too afraid to pull something — anything — out of the bag.

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