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In the last issue of the Fortnighter, I attempted to answer a question on most forward-looking investors' minds – "What sort of return can I expect on my portfolio in the future?" An equally important issue, however - and one that most of us think about far less often, is: "what sort of risk is built into that projected return?"

In the investment business, we take into consideration many types of risk. There's interest-rate risk, business risk, currency risk etc., etc. It's all very interesting, but I suspect the real issue for most investors is the risk of losing money!

Now, can you really lose your money in a properly diversified portfolio of stocks, bonds and cash?? In theory, yes, but the main risk "issue" for the vast majority of portfolios is volatility, not outright loss. It's the variability of returns around the expected return that's important – and keeps us up at night. Even a well-diversified, "balanced" portfolio will demonstrate significant variability in rates of return over short periods of time.

As investors, we understand this. But it's important to know the ***magnitude*** of that variability so that we can be prepared for it when it happens. We also need to have an appreciation of what our portfolio's "tail risks" are – that is, the rare times when volatility is well outside our normal range of expectations (like in 2008).

When recently examining historical return data for my new managed account program, I also looked at the variability of returns for the five investment models I use.

Over the past 15 years, a "classic" balanced portfolio (40% bonds & cash and 60% stocks), had an annual standard deviation of return of about 7.5%. I won't go into a definition of standard deviation here, but essentially it means this: If we expected our balanced model to produce a rate of return of, say, 6% over time, history suggests that 2/3 of the time its annual performance would vary between -1.5% (6% - 7.5%) and +13.5% (6% + 7.5%). 95% of the time, we could expect annual returns to fall between -9% (6% - 15%) and +21% (6% + 15%).

And since many of us are interested in worst-case scenarios (what we call "tail risks"), about 1% of the time we might expect this balanced portfolio to decline by over 15% in value (3 standard deviations). This is, coincidentally, what happened from September to November, 2008.

On the flip side, this balanced portfolio's return in the 3-year period after September, 2008 was almost exactly break-even. Now, 0% is nothing to write home about – but this was one of the worst market declines in 80 years. So, while even a balanced portfolio is "risky" in the short term, that volatility falls off dramatically with even modest extensions of time.