Worshipping the Wealth Trinity

Date: 2016-10-27

In India, we have always worshipped trinities. Hindus worship the female trinity of Lakshmi-Saraswati-Kali as well as the male trinity of Brahma-Vishnu-Shiva. Christians too revere the trinity of the Father, Son and Holy Ghost. In that sense, our worship is centred on three elements of a divine manifestation. But in the world of finance too, there exists a holy trinity. The holy trinity of Risk, Return and Time. And frankly, if you wish to move up in the clergy of the wealthy, you simply cannot ignore this trinity.

An American singer, Jack Yelton, quipped that "there is a very easy way to return from a casino with a small fortune: go there with a large one." In that sense, life is a gamble. From the slipperiness of the bathroom in the morning to the journey back home from work in the evening, every second of our life is rife with risk. Don't be fooled into believing that you're taking chances only when you buy a lottery ticket or visit a casino. Life is risky by nature and every moment is unpredictable.

And risk is inherently tied up with reward. From taming fire and domesticating wild animals to open-heart surgery and landing on the moon, some of humans' biggest feats have come from people stepping outside their comfort zone to try something different. Ancient humans hunted to survive. Predators and the vagaries of merciless nature constantly endangered their lives. Every morning they had two choices: go out to hunt (with the risk of being eaten alive), or starve to death in their cave shelters. We all know which option our ancestors chose.

So let's discuss financial risk. You may be surprised to know that financial risk is not a modern concept. In fact, humans have been dabbling in this for over six thousand years. The people of the Indus Valley Civilisation sailed through choppy seas to visit Mesopotamia and Egypt for trade. As far back as 400 BC, Gujarati traders regularly travelled to South East Asia, carrying cotton, gold and spices. These ancient entrepreneurs bet their fortunes on an unpredictable journey aboard rudimentary ships across vast distances and time. Shipwrecks were common, as were pirate attacks. There was risk of disease, starvation, getting lost. But they persisted because the rewards (returns of 2,000 times the investment) compensated for the risk.

If you read Kautilya's Arthashastra, you will find that 2300 years ago he had prescribed the interest rates that could be charged for extending loans of various types. Household transactions were to attract interest at 1.25% per month (or 15% pa); commercial transactions were to attract 5% per month (or 60% pa); risky travel through forests for trade were charged at 10% per month (or 120% pa); and risky travel by sea for trade attracted 20% per month (or 240% pa). You can clearly see that Kautilya knew that higher risks justified higher rewards.

We've come a long way from the days of our ancestors. Taking risk no longer translates to losing your life, at least not literally. But it's still the same primeval game, only in a different form. Because today we play with risk via the markets. In the world of finance, risk is usually measured as the degree of uncertainty in an expected outcome. Risk is the possibility of losing some, or all, of the original investment. Determining your risk appetite can be tricky. Of course, risk tolerance differs from person to person. It is tied to your income, lifestyle, goals and approach to life. While one might believe that younger folks may be willing to take more risk than the older generation or that the less wealthy may be more risk averse, one has, in fact, seen many instances of the exact opposite.

In order to meet the increasing financial requirements of daily life and maintain a good standard of living, we not only need to save money, but also need to invest it in avenues where one can get maximum returns. However, as the return expectations increase, so do the risks. In that sense, risk and return are two sides of the same coin.

Tragedies occur when people take risk without being aware that they are taking a risk. Investing smartly is more about knowing the risks than the returns. Make no mistake: It's entirely your responsibility to figure out what kind of risk each investment entails, and whether you're willing to take it on. No investment advisor will ever highlight all the risks to you transparently.

Risk rarely announces itself. Rather, you have to dig around for it. Return on the other hand is easy to sell and easy to understand. The problem though is that one can often be fooled into believing that the return on a proposed investment is far higher than what it actually is. The reason for this is that the word "return" can be seen in various ways. How many people actually understand the difference between Absolute Return, Annualized Return, Compounded Annual Growth Rate and Internal Rate of Return?

The relationship between risk and return is often characterised in terms of give and take. You may have heard the phrase "high risk, high return," implying that the more risk you take, the greater your return. Not only is this often incorrect, but also misleading. There are no such guarantees. Just as high risk means the possibility of higher returns, it also means higher potential losses. What's more, in reiterating this common misconception, people ignore a key factor—time. The wealthiest of people did not build their fortunes overnight. Return and time are joined at the hip. Historically, some of the worst short-term market losses have given way to substantial market recovery. Always remember that time in the market is much more important than timing the market.

American money-advisor, Dave Ramsey, says that 'building wealth is a marathon, not a sprint.' Frankly, no one can predict where the market is going. Ignore the headlines. Listen to Anthony Samuelson, a Nobel Prize winning economist who said, 'Investing should be more like watching paint dry or watching grass grow. If you want excitement, take $800 and go to Las Vegas.'

There is an Urdu couplet that says: Paisa khuda toh nahin par, khuda ki kasam, khuda se kam bhi nahin. Money isn't God but, by God, it's no less than God either. Just as Lakshmi, Saraswati and Kali are three manifestations of the almighty, Risk, Return and Time are three manifestations of wealth. Ignore this financial trinity at your own peril.