



15,091 views | May 20, 2013, 09:21am

Stocks Riskier Than Bonds? Not If You Think Like Buffett

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“The riskiness of an investment is not measured by beta...but rather by the probability...of that investment causing its owner a loss of purchasing power of his contemplated holding period. Assets can fluctuate greatly in price and not be risky as long as they are reasonably certain to deliver increased purchasing over the holding period. And... a non- fluctuation asset can be laden with risk.” Warren Buffett (2012)



Warren Buffett, chairman and CEO of Berkshire Hathaway Inc. (Image credit: Getty Images via @daylife)

Some of the [latest research\[i\]](#) by [Javier Estrada](#), professor of financial management at [IESE Business School](#), challenges conventional thinking about the relative risk of stocks and [bonds](#). Most investors view stocks as riskier than bonds because they fluctuate more and, in the short-term, Estrada’s research clearly suggests this is the case too. But, as Estrada points out, long term risk - something Buffett focuses on - should also be considered when assessing these two assets. After all, individuals are often saving for retirement, which can be several decades away.

Defining Risk

Crucial to any assessment of the relative risk of these assets is, of course, firstly determining what we mean by risk exactly. In his paper, Estrada explores some of this debate: risk has no universal definition, and while modern financial theory defines risk as the standard deviation of an assets returns, numerous other definitions have been proposed by academics, practitioners, and investors. Of the

four measures of risk considered in Estrada's article (standard deviation, semideviation, worst-case scenario, and spread) all suggest that in the short term stocks are riskier than bonds. Yet when it comes to long term risk, it is a different story.

Bonds "the most dangerous of assets"

Warren Buffett argues that long term risk should not be measured by how much an asset fluctuates, but by the probability that it destroys purchasing power over the intended holding period. When looked at from this angle, bonds are, according to Buffett, among "the most dangerous of assets" and "their risk is huge". In his research, Estrada assesses long term risk using Buffett's definition (the probability that stocks and bonds destroy purchasing power over 20/30 year holding periods) and also complements it with another measure of long term risk - the probability that stocks deliver less purchasing power than bonds over the same period.

The data Estrada uses to evaluate the relationship between the relative risk of stocks and bonds and the holding period comes from the Dimson-Marsh-Staunton (DMS) dataset, which covers 19 countries and the world market over the 1900-2009 period. All returns are annual, real (adjusted by local inflation), in local currency and account for capital gains/losses and cash flows (dividends or coupons.)

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Estrada finds that in the long term, the data suggests 1) stocks are very unlikely to destroy purchasing power; 2) stocks are far more unlikely to destroy purchasing power than bonds; and 3) stocks are very unlikely to deliver less purchasing power than bonds.

In other words - as long as investors agree with Buffett's view of long term risk, the data clearly suggests stocks *are* less risky than bonds.

[i] forthcoming in the *Journal of Asset Management*



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