**Recognising risk**
**(July 2005)** **by Selestia's Head of Investment Marketing, Graham Bentley.**

Understanding the dynamics of any investment opportunity requires us to recognise three basic elements:
· *Expected Return* – The average return an investor might expect, if he were to make exactly the same investment many times through history
· *Variance* – How far from the expected return the actual result could be
· *Risk* – The consequence of not getting what you expected
This last point is very important. Imagine I have three playing cards, two red and one black, face down on a table. The probability that you will select a red card is 2-1 on, or 66%. If you bet £1 and draw a red card, you get your £1 back, plus 50p. You may not regard this as risky. If I play this same game again, with the same three cards, the odds on me drawing a red card remain the same, so is the risk the same? Well suppose I change the stake – now bet your house. The chance of drawing a red card stays the same, but the bet feels very different because the *consequence* is potentially more damaging - risk is meaningless without a consequence.

Now bearing this in mind, consider client attitudes to risk. If I offer you a bet that has an 80% chance of winning £4000 and a 20% of winning nothing, versus a second bet that has a 100% chance of winning £3000, I dare say you'd take the second bet. The first bet is the so-called rational decision because it has a higher expected return of £3200 (80% of £4000). However, this ignores the fact that we are playing the game only once, and at least the second bet has no chance of a loss. Choosing the second bet would seem to indicate that we are risk averse. But suppose I reframe the bet, so that the offer is an 80% chance of losing £4000 and a 20% chance of breaking even, versus a 100% chance of losing £3000. Now which do you choose? Most people would take the first option even though it is likely the losses would be even higher, in order to cling to the low probability that they may avoid a loss. This demonstrates that investors are typically *loss*-averse, not risk-averse. Consequently investment decisions should be taken to account for the potential for loss of a portfolio over its expected life, rather than simply focusing on volatility. Nobody minds volatility on the upside – *after the fact*

There are two major influences on the likely behaviour of an investment portfolio, Systematic (or Market) risk, and Unsystematic (or Specific) risk. Systematic risk is that which impacts on the market as a whole, e.g. unexpected interest rate rises or falls. Unsystematic risk is that which attaches to a single stock, e.g. earnings surprises, employee strikes etc. There are then risks which attach to particular types of security. Investors who hold corporate bond or gilt funds in their portfolios will be affected by three major influences - Credit, or Default risk, Interest Rate risk, and Inflation risk. Credit risk relates to the ability of a company or government to pay the contractual interest or capital on its debt obligations. Government bonds have the least amount of default risk and consequently the least amount of compensation for that risk (i.e. returns) while Corporate bonds tend to have the highest amount of default risk but also the higher interest rates. Bonds with lower chances of default are considered to be "investment grade," and bonds with higher chances are considered to be "sub-investment grade. A default doesn't necessarily mean the company or the country concerned has gone bust. A single missed payment is classed as a default, as it is when you miss a credit card payment. Where a country defaults (i.e. Argentina in November 2001) this will affect not only its debt market, but all its traded securities, including equities, and those of other similar credits (e.g. Emerging Markets). Interest Rate risk,

usually via a rise in short-term rates, hurts the performance of both equities and bonds, because the costs associated with servicing that debt rise. Bond interest rates become relatively less attractive compared with the risk-free rate, and so to maintain the yield differential prices have to fall because the interest payment is fixed. Companies' ability to generate profits is compromised because their costs rise – thus equity prices may fall to compensate. Similarly inflation has a serious impact on bond prices, because the purchasing power of a fixed interest security is inversely proportionate to changes in the inflation rate. There is an upside to this relationship, however. Much of the current vogue for buying Bond funds can be traced to January 1982, when interest rates and inflation worldwide began their 20 year mutual fall, thus driving prices upwards as yields fell.

Another, and often misunderstood risk, relates to currency. Foreign exchange risk applies to all financial instruments that are in a currency other than your domestic currency. A UK investor who invests in US equities is holding dollar valued securities. Even if the share value appreciates, you may lose money if the US dollar depreciates in relation to sterling at a faster rate than the market grows (as has been the case until recently). On the other hand, your portfolio can benefit from the influence of exchange rates, because if the relevant exchange rate is less volatile than the market you are investing in, or their covariance is negative, then the market risk is reduced.

Other risks are related to unexpected, non-market related occurrences. Event risk can impact on a whole asset class (uncovering Enron's accounting fraud) or the global market (September 11 2001). Political risk can have a similar effect on a local market (a surprise election result) or globally (demise of the Soviet Union). It is often argued that these risks can be completely avoided – you can have your cake and eat it – by using synthetic or structured products thereby gaining some kind of protection or "guarantee". Even these arrangements have risks, particularly counterparty risk (that the underwriter of one side of the trade defaults) and liquidity risk (that the cash is not available, e.g. because the security cannot be sold. This can be the case with Property).

Risks abound and attach to every investment, but you would be hard pressed to find a scenario where every asset class fell, in every country, at the same rate and at the same time. The only sensible route to mitigation, therefore, is diversification. This involves establishing a client's minimum acceptable return and maximum downside in any single year, and constructing the portfolio which is currently deemed to be most likely to deliver, within those constraints, over the life of the portfolio. All available asset classes, including Commercial property, should be utilised, to take advantage of as many low correlated assets as possible. No region should be ignored. In the same way that bread requires unpalatable flour, so Emerging Markets and Japanese Smaller Companies may seem dangerous in isolation, but their addition to a portfolio can reduce risk and potentially enhance returns, as we have seen over the last 2 years. The regional asset classes, e.g. UK Equities, should then be sub-divided to gain exposure to different styles, e.g. Value, Growth, Small cap etc; a useful proxy is to use at least one fund from each relevant major IMA sector, ie three UK Fixed Interest funds (UK Gilt, UK Corporate Bond and UK Other Bond), 3 UK equity funds and so on.

Finally, it shouldn't matter how large or small the client's investment – everyone should be diversified according to their requirements. Even Shakespeare recognised this:

"I thank my fortune for it, my ventures are not in one bottom trusted, nor to one place: nor is my whole estate upon the fortune of this present year; therefore my merchandise makes me not sad."
**Antonio, The Merchant of Venice, Act1 Scene1.**