Volume 3 //

Acuity

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The greatest wealth is **your peace of mind**...

If risk is the answer, what is the question?

> "Risk surrounds and envelops us. Without understanding it, we risk everything and without capitalising on it, we gain nothing."
> **Glynis Breakwell – The Psychology of Risk**

Is risk a bad thing?

The risk pendulum has swung a long way since the 16th Century in England. Recently researched coroners' reports on accidental deaths in Tudor England revealed a far more *laissez-faire* attitude to risk than we have today. Apparently 56 accidental deaths occurred in one year from people standing too close to archery targets or those who decided on just the wrong time to go and collect the fired arrows[1]. Where were their Health & Safety risk assessments? Today, a greater focus on risk management has altered our behaviour and attitudes, resulting in an increasingly risk-sensitised and risk-averse society – long gone are the fire-lighting and axe-wielding activities in outdoor venture organisations for children that many will remember.

Everyday we are faced with 'risk' choices, from crossing the road or using a chainsaw, to the long-term health risk of that tempting doughnut, cigarette or final glass of wine. Often we make these risk decisions instantaneously, perhaps intuitively, often naively or sometimes with reckless disregard for, or understanding of, the outcome.

In some ways, the investment programmes of many individuals are run in a parallel manner. Many investors arrive at an advisor's door with their entire investable wealth sitting in cash deposits, due to an inertia caused by the complex and difficult risk choices they face. Their current position is in itself a long way from being risk free. Aside from the risk of a bank going bust (credit risk), inflation risk has eroded almost 7% of their wealth in the past two years.

Risk can be good too – it sits at the centre of a good investment process

We have grown used to thinking of risk as a bad thing, but we need to change our mindset and embrace risk in an intellectually robust and controlled way. The quote that heads this page sums it all up with the words *'Without understanding it, we risk everything and without capitalising on it, we gain nothing'*. As investors, we need to follow this sound advice making sure that we fully understand the broad gamut of risks that we face.

We need to understand what risk means in the context of an investment programme, comprehensively identify the risks we face, select those that will be positive contributors to our portfolios and avoid or mitigate those that we do not want to experience. That is what a robust investing process is about – it is not about chasing returns. Get the risks right in a portfolio and the returns have every chance of being delivered. Without a systematic process for managing risk we are simply gamblers, not investors. While this may appear logical and simple, in practice it is not easy.

What is risk?

Before we get ahead of ourselves, it probably makes sense to stop and think about what risk actually is. At its very basic level risk can be defined as: the *probability* of an *adverse* event (*hazard*) happening and the *effect* of this exposure due to a specific hazard *on you*. The words in italics are critical, particularly as each is often open to interpretation or estimation. In short, risk is the product of the probability of a hazard occurring and the impact it will have. Risk registers held by organisations such as schools and hospitals are set out on this basis, with risk mitigation strategies addressed.

Risk decisions involve weighing up the risk, against the benefit derived from taking it. To make good risk decisions means gaining an accurate handle on both sides of the risk-reward equation. In essence, that is the *raison d'être* of a robust investment process.

Why do we find making risk decisions so hard?

The short answer is because we are human, and despite the amazing qualities of the human mind, we are programmed to behave in ways that help us to survive, not to make good investment decisions[2]. As the legendary investor Benjamin Graham stated:

"The investor's chief problem – even his worst enemy – is likely to be himself"

Psychologists and others who study human behaviour, both outside of and within the world of finance have discovered a broad number of identifiable flaws in the way that human beings think. First of all we are hopeless at estimating probabilities (and maths in general), second we are riddled with innate biases and third, we are highly susceptible to the way in which problems are framed. For example, a commonly used rule of thumb for an acceptable level of income in retirement is 70% of income at retirement. Yet if the discussion with the client is framed in the context of the 30% income that must be eliminated from their lives, people find this unpalatable, despite the mathematical equivalence of both.

These challenges are compounded by the way in which risk is communicated. By and large the investing world suffers from risk myopia, focusing on the statistical properties of the patterns of short-term returns and using phrases like '*the annualised standard deviation of returns of this portfolio is...*' which, unsurprisingly, means next to nothing to most people. See footnote for an explanation.

Emotional decision making

We seem reasonably well programmed to make sensible risk decisions for immediate and everyday risks, such as crossing the road. We have two main ways that we make decisions – emotional and logical – the origins of which reside in different parts of the brain, with those associated with emotions in the older part of the brain, from an evolutionary perspective. Emotion has been designed by evolution to trump logic.

The problem is that our emotional decision making tends to kick in when problems are badly structured and complex; when we have effects or goals that are ill-defined; when we feel we have too little, or poor, information; and when we feel under pressure. Risk decisions require estimates of probability and effects, which we are pretty weak at working out logically in our heads. Making financial decisions in general, and more specifically investment decisions, fits into this category. Logic, discipline and common sense are our friends.

An explanation of investment jargon:

In a statistical sense, risk is the annualised standard deviation of returns. We do not need to worry about how it is calculated, but it is worth knowing how to interpret a 'risk' figure as it does provide some useful insight. All a risk percentage figure that you may see on a fund or portfolio fact sheet means is that 2/3 (67%) of observed returns fall within the range of this risk percentage (otherwise known as one standard deviation) either side of the mean return and 19/20 (95%) of returns fall within a range of two standard deviations either side of the mean.

This can be a useful insight, if you do some simple maths, providing a rough and ready indication of how bumpy your investment ride could be. A hypothetical portfolio (or fund or asset class) with an average return of 5% and a risk of 10% exhibits a range of returns from -5% to +15% (i.e. the average return of 5% +/- one standard deviation of 10%) that captures 67% of all return outcomes. A range of +/- two standard deviations from -15% to +25% captures 95% of all observations – see figure 1 below.

Figure 1: What standard deviation (risk %) means

		Range captures 67% of returns				
	Range captures 95% of returns					
Range captures 99% of returns						
-3 SD below	-2 SD below	-1 SD below	Mean	+1 SD above	+2 SD above	+3 SD above
-25%	-15%	-5%	5%	15%	25%	35%

What are the risks in an investment programme?

From an investment perspective, the risks can be split into three key areas:

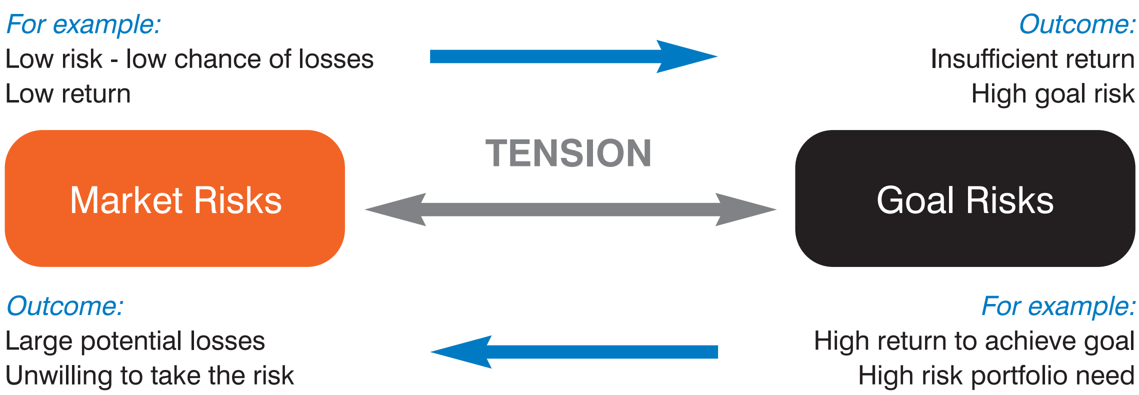
Market risks: these are the risks of participating in the capital markets either by being a part-owner of companies (equities) or a lender (bonds) and capturing the rewards that capitalism delivers for doing so. From time to time investors will suffer shorter-term losses. The degree to which they do will depend on the mix of risks that they own in their portfolios. Investors face a number of critical risk choices, which need to be made with due care.

Implementation risks: these represent the risks that can erode the market returns that capitalism delivers, as described above. They range from high product costs and the risk that a fund manager underperforms the market[3], to a broad array of other inadequately rewarded risks, such as owning very illiquid investments. A methodology for identifying, analysing and avoiding or mitigating these risks is essential.

Goal risks: these represent the risks associated with failing to meet the long-term goals established by an investor, whatever they may be. Understanding the goal risks to any long-term plan is a good start, and is achieved through some form of scenario planning, focusing on worst-case outcomes and the probability of failing to meet the stated goals. An example would be knowing that the chance of running out of money, even if market returns are poor, is low.

For a client to have a high likelihood of their investment experience being a successful one, each of these risks needs to be identified, understood, and managed in a practical and proactive way. A tension often exists between market risks and goal risks which needs to explored and effectively managed, through a combination of risk tolerance testing (see below), education and sound financial planning work. In an ideal world we would preferably take no, or little, risk to achieve our goals, but that is rarely reality – we generally must take some risk.

Figure 2: The tension between short and long-term risks (market versus goal risk)



What market risks should we take?

Whatever you think about Donald Trump, his words of advice on investing make an awful lot of sense.

> *'Sometimes your best investments are the ones you don't make.'*

A carefully constructed investment process will seek to take risks that are fully understood, quantified and that deliver adequate rewards in compensation and, just as importantly, to avoid those that are not. The selection of market risks (i.e. the types of investments we choose) needs to be based on whether they meet certain key attributes that we have defined. Those that fail to make the grade are avoided. Market risks are not considered in isolation but at a portfolio level. The goal when constructing client portfolios is to create a basket of risks that:

- is broadly diversified across securities, markets and asset classes (e.g. equities, bonds)
- offers a robust and attractive ('*efficient*' to use the industry jargon) relationship between risk and reward
- delivers a level of risk (and thus return) appropriate for the client's circumstance
- exhibits a range and pattern of returns time that is both understood by and acceptable to the client.

At any portfolio's core should be a focus on the risks of capitalism, being the part ownership of global companies (via equities) and lending to high quality governments and companies on a short-term basis (bonds) and perhaps with built-in inflation protection offered by inflation-linked bonds. Our client portfolios also include moderate allocations to other investments that contribute to the overall portfolio, such as commercial property, or an overweight position to smaller companies.

How much market risk can we tolerate?

Understanding how much market risk we feel comfortable with is a critical element in deciding what level of risk we should own in a portfolio. Risk tolerance questionnaires, particularly well structured psychometric tests[4] that measure an investor's risk tolerance trait - an innate and constant characteristic of character - provide a useful input into the risk discussion. Portfolio profile sheets, visually exploring the characteristics of different portfolio structures, are a useful tool too.

How do we minimise implementation risks?

The goal of a successful investment programme is to take a broad range of risks that are adequately rewarded and deliver the returns on offer from the capital markets. Implementation risks are those that are likely to erode these market-driven rewards. These include:

- Trying to beat the markets by using 'active' managers
- Attempting to decide when to be in or out of markets (risks)
- Getting involved in complex, opaque and costly products such as hedge funds
- Making illiquid investments that are not easy to sell
- Suffering high costs - both financial and emotional

Success is achieved only by investing in what we fully understand and have confidence in, supported and controlled by a disciplined investment process. We believe that too many unnecessary risks are taken with the express purpose of making advisors look cleverer than they are. As Warren Buffett says:

> *'Risk comes from not knowing what you're doing.'*

Product due diligence and process governance

Detailed and insightful due diligence is part of a disciplined risk management process. It is evident that there was a considerable lack of care by many well-known names when it came to the Madoff 'Ponzi' scheme – the biggest investment fraud in history. A rigorous focus on understanding a product, where its risks lie and evaluating if these are acceptable, are an integral part of managing risk and need to be embedded in a strong due diligence process. Risk decisions, including product discussion and approval, lie within the remit of our Investment Committee[5], which is responsible for ongoing process governance - the review, reaffirmation and evolution of our investment process.

How do we manage goal risk effectively?

While much is made of the market risks of investing, perhaps the biggest risk that a client faces is that their financial goals and, by extension, lifestyle goals are not met. Common goal risks include running out of money, or portfolio assets falling below a level capable of funding a minimum lifestyle threshold.

The use of lifetime cash flow planning, and the ability to run different investment 'worst-case' scenarios, either using historical 'worst-case' periods or modelling portfolio return uncertainty in more sophisticated way, can help to gauge how likely a strategy is to be successful, in the face of the market return uncertainty that is faced.

The more comprehensive the risk discussion between a client and his or her advisor, the more likely it will be that the client's goals will be met, without undue concern or sleepless nights in the interim. Defining the appropriate level of market risk to take in a portfolio is a trade-off discussion between how much market risk an investor is willing to take, his or her financial capacity to live through any market trauma, and the financial risk that is needed to reduce the level of goal risk in the client's financial plan.

Getting the risk answer right is one of the most valuable contributions an advisor can make for a client, along with managing these risks into the future. As a consequence, the client is likely to have a high chance of a successful outcome and a journey that is both comfortable and rewarding and, at worst tolerable.

Figure 3: Summary of investment risks and how they should be controlled

	Market Risks	Implementation risks	Goal risks
Hazard faced	Return uncertainty Portfolio losses	Erosion of market/returns Product blow-ups/fraud	Not meeting goals
Effect on you	Anxiety Abandoning strategy	Poor compensation for risk Impacts achievement of goals	E.g. running out of money Lost opportunity
Probability estimate	Risk % (standard deviaton)	Qualitative/quantitative estimates Research evidence Cost estimates (all kinds)	Likelihood of acceptable outcome (scenarios and other simulations)
Mitigation - investor	Risk tolerance testing Understanding portfolio characteristics	Discipline Education	Understanding the plan Accepting the short-term tension
Mitigation - process	Evidence-based process Careful risk selection Broad diversification at all levels Robust portfolio construction	Risk identification Careful assessment (risk/reward) Product due diligence Formal risk discussion/sign-off	Flexibility within the plan Lifetime cashflow modelling Ongoing stewardship
Ongoing management	Rebalancing Investment Committee overview	Ongoing product review Investment Committee overview	Regular reviews Communication

Conclusion

The whole issue of risk, as we can see, is complex and one that most humans are ill-equipped to handle without considerable guidance and support.

Establishing the correct level of risk is not easy; managing market risks in a portfolio across time is not easy; avoiding unwanted risks is not easy; controlling risk on an ongoing basis is not easy. The route through this complexity is a robust investment process, overseen by a risk-orientated governance process driven by a risk-focused Investment Committee. We have spent considerable time and energy in implementing such a process.

As investors we need to embrace risks of the right kind, avoid those that we wish to avoid, stop ourselves from diluting the power of the capital markets through weak implementation, and make sure that we find the right level of risk to achieve our goals, while being able to sleep at night. If we can do that, the outcomes that we are seeking will surely follow.

Take-home points

- Risk is an integral part of investing: not all risk is bad
- Unfortunately we find making sensible risk decisions quite difficult – the human mind defaults to intuitive, emotional decision-making processes to handle complex, uncertain and unclear decisions.
- Three key areas of risk exist: market risks, implementation risks and goal risks. A natural tension often exists between market and goal risks that must be resolved.
- Strong ongoing governance is central to protecting client wealth over time.

We hope that you have enjoyed this volume. Please do not hesitate to call if you have any questions or comments on it, or if you would like to discuss our robust investment process in more detail.

End notes

1. http://www.bbc.co.uk/news/magazine-13762313 (It is worth a read for amusement.)
2. In Acuity Volume 1, 'How to be the world's worst investor! (Common and costly mistakes to avoid)' we explored how our emotions make us inherently prone to making costly investment decisions. Please ask if you have not received this volume.
3. There is an ever growing pile of evidence that demonstrates that market-beating managers are extremely rare and well nigh impossible to pick up front. In our view, the risks of underperforming the returns of an index (tracker) fund are not compensated adequately by the probability of accessing long-term, market-beating performance.
4. Psychometric risk tolerance profiling: a client's financial risk tolerance is a psychological trait that is a consequence of their genetics, as well as their learned values, motivations and attitudes towards financial risks. It appears that there is some positive correlation with the level of income, wealth and education (i.e. the higher they are, the higher the risk tolerance is likely to be) and negatively with being in a relationship and the number of people that rely on the investor. Psychometric risk profiling is only a guide in the discussion process and is not designed to 'pick' portfolios – it is the starting point of a clear and comprehensive discussion of risk with the client.
5. Our formal Investment Committee meets regularly throughout the year. It provides the forum for reviewing, discussion and agreeing the multitude of investment decisions that we make on behalf of our clients, and maintaining the highest quality of decision-making over time. Meeting minutes provide a written record of these decisions.

Other notes and risk warnings

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