Matchmaking risk and return

Careful selection of assets, taking into account clients' needs and tolerances, can effectively remove speculation

Risk, rather like beauty, is in the eye of the beholder. It is a little word for a very big subject. A dictionary definition of risk is: 1) The possibility of suffering harm or loss; 2) A factor, element or course involving uncertain danger or hazard. In this article I shall focus on controlling risk, whilst aiming to capture as much return as possible. The starting point is based on the assumption that the investor has a number of life objectives which are very dear to him and his family. These lifestyle objectives have certain financial values and timeframes.

There will be a defined starting point in terms of existing resources as well as any expectation as to additional resources, for example, through future savings, sale of a business or inheritance. In determining the risk that needs to be taken so that there is a high probability of all the objectives being met, we must first agree some assumptions. These will include timeframes, including start and end dates, and future inflation. This determines the extent of the liabilities that have to be met. All this information will enable the adviser to prepare a lifetime cashflow forecast. From this, a rate of return required from the portfolio can be determined.

A key question that arises from this part of the exercise is – are these objectives and timeframes feasible? If not, could they be if the rate of return on the portfolio is increased – and is that realistic? These initial steps determine the purpose for investing. Without taking these steps, it would be difficult to work out the level of risk that needs to be taken by the investor.

In helping to advise the client on the possible solution we must look at a number of risks that need to be addressed. The first of these is the risk tolerance of the investor.

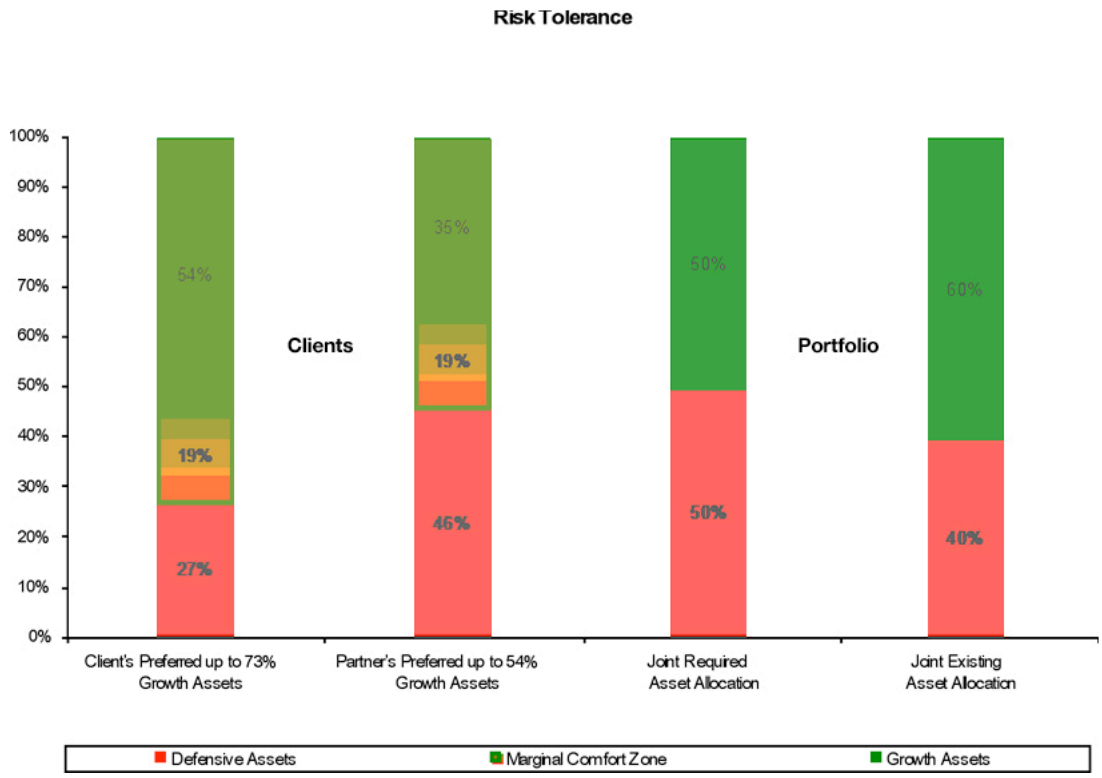
Understanding the risk tolerance of the investor is of vital importance which can be difficult to achieve in a meaningful way. The danger is that unless the adviser asks the right questions in a way that the investor understands, the information derived can be of little value.

PSYCHOMETRICS

What does, for example, medium risk really mean? And if it means one thing to the adviser, does it mean the same thing to the investor? Fortunately, scientifically validated risk profiling systems based on psychometrics – which is a combination of psychology and statistics - are now available. These systems help overcome this potential mismatch of understanding.

However, in order to gain maximum value out of these systems, it is important that the adviser understands how they work. In essence, the outcome of these systems is fundamental to the discussion that the adviser and investor need to have about the relationship between risk and reward. The first stage is identifying where the investor's natural comfort zone lies and is an indication of the type of portfolio with which the investor will feel comfortable. It is measured in terms of the proportion of the portfolio that can be held in growth assets – usually equities and property – with the balance held in defensive assets – usually cash and bonds. There is a fair degree of latitude between a portfolio that falls within the comfort zone and one with which the investor is likely to be distinctly uncomfortable.

It also highlights any differences in the natural comfort zones between partners. There is always some difference and in some cases it is considerable. For example, one partner – all too often the male – will have a higher tolerance than the other partner. How do we deal with this? Will they accept a compromise; if so, on what basis?



The second part of this exercise, is to compare the optimum level of risk necessary for the investor to achieve his goals (derived from the preparation of the lifetime cashflow) against his natural comfort zone – and also against the risk already being taken in his existing portfolio. It often surprises clients just how much risk they are currently taking. If the required level of risk is beyond the investor's tolerance level then some adjustment needs to be made to one or more of the risk level, financial requirements or timescales.

From this, a broad asset allocation policy can be determined. How much should be allocated to growth assets – to generate return and how much to defensive assets – to control volatility? Before we look at this in more detail, it is worth segregating an amount to cover known short term (say up to three years) liquidity requirements and a contingency from the main portfolio. The asset allocation will determine the overall risk characteristics of the portfolio.

ALLOCATION

Much discussion has taken place discussing the merits of the findings of Brinson, Hood and Beebower who, in 1986 and again in 1991, argued that asset allocation was the major determinant of the variability of portfolio returns. Unfortunately, these findings have often been misunderstood as the value of portfolio returns. Clearly, a portfolio comprising a number of asset classes that have low correlations one with another is likely to be less volatile than a portfolio of highly correlated assets.

Following on from asset allocation is diversification. Diversification goes much further than just the number of asset classes. It is looking at the number of shares included within each asset class. Arguably, a portfolio with say twenty shares within just one or two asset classes has a lower probability of providing the return required to

meet the investor's financial requirements than one with several thousand shares spread over up to a dozen or so asset classes. The other point is that the risk inherent in the first portfolio will be considerably greater than that in the second. These were the findings made by Harry Makowitz in 1952 – now known as Modern Portfolio Theory. Two other important points that go with diversification are the need to remain invested and to think long term. Trading is expensive; timing is usually woefully wrong and when markets rise they often do so in short busts and when it is least expected!

Based on data of historic returns, particularly over the long term – twenty years or more – it is possible to determine the characteristics of each asset class in terms of expected volatility and returns. Portfolios can be constructed to meet a particular volatility and return objective. However, a caveat is required here. The only evidence that is available is, of course, historic; the future is bound to be different and past returns are unlikely to be repeated!

Developing an investment policy statement tailored around the investor's particular requirements is helpful in explaining how the portfolio should be established, reviewed and rebalanced. It becomes the investment 'highway code' and the document should be referred to regularly. There will be times when investment decisions are emotionally difficult to make, such as in turbulent or exuberant markets – but by referring to 'the rules' the reasons why action should be taken will be there for all to see. Neither Sir John Templeman nor Warren Buffett would have become investment gurus had they allowed emotions get in the way.

A word on selecting defensive assets, particularly bonds. Research shows that the difference in total returns between long and short dated bonds is not that significant. If only the same could be said for volatility. Unfortunately, long bonds have tended to display volatility characteristics which would not be out of place in an equity portfolio, but without benefiting from the reward that is expected from that level of risk. Consider limiting the investor's exposure to just short maturities and also index linked gilts which will provide a risk free real rate of return if held to maturity.

SPECULATION

The important point to remember is that this approach to portfolio design takes away virtually all the elements of speculation. It is therefore possible to rely upon the market return from each asset class rather than betting on a higher return through the selection of a limited number of shares. The market rewards investors for taking risks by providing capital. If no reward was forthcoming, capitalism would have collapsed long ago. In order to achieve a higher return than the market rate, investors are speculating – which is the consequence of selecting a limited number of stocks. I wonder just how many investors realise this?

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