momentum

What is risk?

Re-evaluation traditional measures of risk portfolio construction

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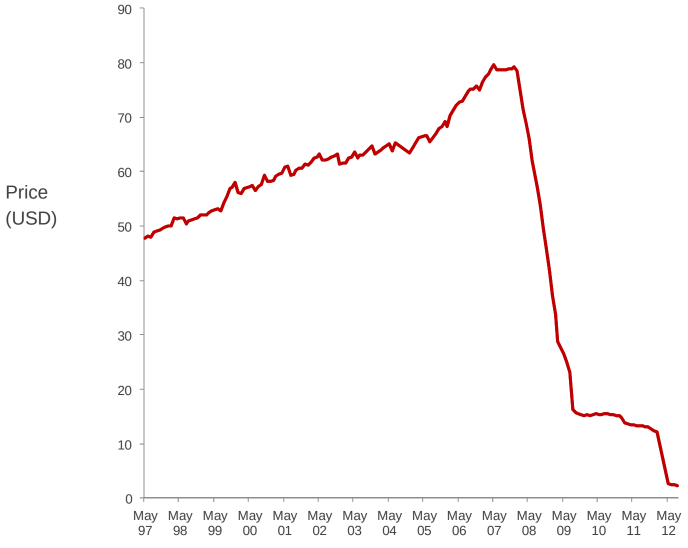
Introduction

As investors we have all been educated (or *conditioned*) to believe that risk is volatility. This makes sense insofar as movements in the price of one's investments certainly *feel* risky. At Momentum Global Investment Management we try to look at risk in subtler ways. The reason we do this is because volatility, while uncomfortable and distracting, is not in and of itself a risk in many instances. Rather, volatility is the manifestation of risk. As a result, we believe that as portfolio managers we should be adding value for our clients by looking past the perceived risk – the manifestation of risk – towards the underlying risks themselves, in order to provide a more coherent portfolio. This approach does not necessarily lead to the lowest volatility portfolios on a day-to-day basis (although it does tend to help on this front) but rather it reduces our clients' exposure to true risks that can be low in volatility terms but high in the sense of their true risk for investors. The true risk for investors is the permanent loss of one's capital, as we will now go on to discuss.

Real risk: permanent losses

We believe that the real risk that investors must look to conquer is the permanent loss of their money. This sounds like a relatively trite statement, but it is in fact subtly different from the notion of temporary losses which are, generally, a consequence of volatility. Permanent losses are, therefore, the ones that we have no hope of making back – with the result that part of our portfolio is permanently impaired. When playing the stock market directly investors tend to understand that there is a risk, however slim, that their investments may go to zero. This reality is less often appreciated in funds – and thankfully it is also less likely – but it remains a risk and one that we should not disregard outright. Below is the price chart of a fund that has experienced permanent impairment of capital. While it is still a going concern, we suspect that the investors left in the rump of this fund will be disappointed in the end. This fund was undone by a heady mix of leverage, hot money and a mismatch between the liquidity terms of the fund and those of the asset class into which it invested. This is a risk that would not have identified by simply looking at the volatility of the fund's returns during its heyday (between 1997 and 2006). This is because historical volatility tells us little about future risks. While permanent losses are the single biggest risk for investors, risk does come in a variety of guises. The most effective method to reduce the risk of permanent impairment of capital is to have an effective operational due diligence procedure in place alongside one's investment due diligence process.



Data source: Bloomberg, October 2012

Undershooting your investment needs

Despite this idea that real risk is about losing money in such a way that it cannot subsequently be earned back, an alternative risk to investors with specific long term investment requirements is earning inadequate returns. This is a particular risk for today's investors for a number of reasons. Firstly, income available from traditional 'low risk' sources such as government bonds or cash is extremely low at present. Secondly, given the increased proliferation of defined contribution pensions (as opposed to defined benefit schemes) the investment risk is increasingly being borne by retirees rather than their pension sponsors. Crucially, this change to the pension landscape comes at the same time as rising life expectancy, and as a result planning with respect to longer term investment provision is even more important. Finally, in addition to the above factors, investors on the whole are understandably cautious at present given the two bear markets that we have experienced in the space of a decade. If investors are unwilling, or unable, to take a level of risk that is appropriate for their long term requirements there is a good chance that they will undershoot their investment expectations.

Short termism

A related risk for investors is being too fixated on short term returns. We live in a world of 24-hour news; but this is a world where *quantum* of information is certainly not the same as *quality* of information. It is harder now than ever before to invest for the long term because we are continually being bombarded with information which appears to validate or undermine our decisions. The reality, however, is that this information is unlikely to show either. This is because generating long term returns also requires a long term investment mindset. Worrying about returns too much in the short term can be a problem. Having a longer term mindset enables genuine investment in assets rather than speculation on short term market moves. If one is able to approach the markets in this manner it provides the opportunity to embrace volatility rather than fixate on it, and to take advantage of others' short termism for your own benefit. Furthermore, fixating on short term market moves can be incredibly stressful and lead investors to move their portfolio in haste, in a manner that actually is not in their best interests. This is related to our behavioural finance driven shortcomings, to which we now turn.

Your inner chimp

All investors are subject to frailties caused by behavioural quirks. Behavioural finance is the study of the effects of social, cognitive and emotional factors on investment decisions. As a result, it is important to bear behavioural finance theory in mind when investing, as these character traits pose a risk that needs to be overcome. The most brazen example of the shortcomings inherent in all of us is our propensity to become overcome by fear or greed. Sadly history tells us that this often comes at exactly the wrong time. Whether it is Tulipmania in seventeenth century Holland, the tech bubble in the 2000s or the collective shunning of the equity markets in periods of stress, market participants can clearly be susceptible to strong attractive or repulsive forces as a result of innate fear or greed. A longer term investment mindset helps to mitigate some behavioural finance factors, as does having a robust and repeatable process. Others believe that being 'contrarian' in nature is the ultimate foil to behavioural finance; as Warren Buffet explains, "attempt to be fearful when others are greedy and to be greedy only when others are fearful". At Momentum GIM we bear all of these issues in mind when investing and constantly challenge our innate biases to ensure that the decisions we take are in the best long term interests of our clients. Ultimately a well designed, robust and repeatable investment process, which places emphasis on largely objective measures such as valuation, reduces our sensitivity to behavioural finance shortcomings.

Unnecessary complexity and 'assumption rich environments'

As the proliferation and then collapse of the CDO market demonstrated in 2007/8, over complex investment strategies can be rife with assumptions that all work together harmoniously until, abruptly, they don't. Unfortunately in many instances there is no way to predict when hitherto benign relationships cease to work together. Worse still, a lot of these instruments have low volatility right up until the point at which they cease to function effectively. As a result a pure focus on historical volatility may suggest that investments of this sort are low risk, when in fact, only detailed analysis of what is beneath the surface can reveal the real risks of such a structure. Sadly, the CDO debacle demonstrates that even bright analysts can miss the inherent dangers in some assumption rich environments. Consequently we try to keep it simple with respect to our investments, on the basis that unnecessary complexity often masks risks that we do not know we are taking.

Fighting the last war

One risk for investors, which is related to a number of the points identified already, is our tendency to spend our time fixating on mistakes already made. As humans we have an illustrious history of protecting ourselves against risks that have already passed, such as The Maginot Line which was constructed along parts of France's Eastern borders to protect it from the static and defensive style of conflict which characterised the First World War. Needless to say that the line was strategically ineffective as new tactics employed during the Second World War changed the face of warfare. From an investment point of view, while a degree of introspection is healthy, what many investors are at risk of doing is expecting that the negative (or positive) events of the past will be repeated. This is most notably the case following a period of significant market falls after which investors feel compelled to prevent themselves from making the same mistake again. The problem with this approach is that tomorrow will bring with it new and hitherto unforeseen mistakes and opportunities. As a result we need to be forward looking when making an assessment of what is likely to impact our investments rather than being backward looking. We need to build insurance in our portfolios for tomorrow's problems, not yesterday's. Furthermore, as many investors seek to protect against yesterday's mistakes at the same time, it becomes expensive. Consequently investors often overpay for insurance that they will never use, while ignoring cheaper alternatives that would genuinely benefit portfolios.

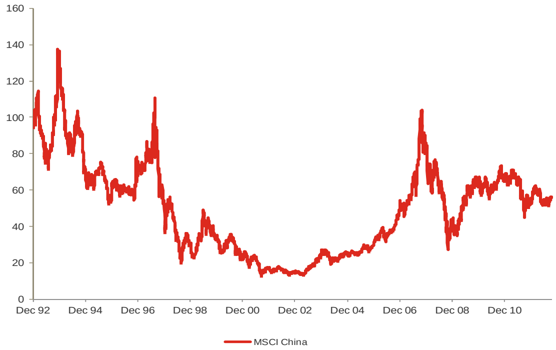
Regulatory environments

There is a risk that regulatory environments change. As a result, an investment strategy that relies largely on regulations for its profits, rather than a sound investment case, is a risk. The particular risk in this instance is that regulations can change and if they do the case for holding your investment could evaporate. As a result, investments must be based on a sound investment principle that is independent of a favourable regulatory regime.

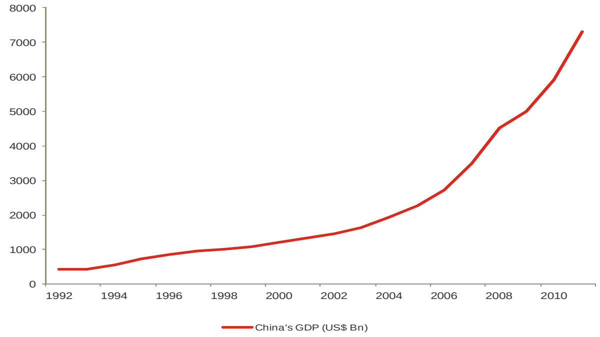
Confusing a macro story with an investment case

Investors often make the mistake of confusing a solid macroeconomic story with a good investment case. While there are inevitably relationships between economic performance and the performance of businesses, there need not be a direct link to stock prices. As a result, when investing, it is a risk to confuse a macro story with an investment case. In fact this goes further still. Not only is it a risk to confuse a macro story with an investment case, but it is also a potential mistake to confuse a good business with a good investment. It need not be that case that a good business is a good investment if it is bought at the wrong price. The first principle of valuation driven investment is that the company's share price must be lower than the intrinsic value of the business. A brief compromise between China's stock market and GDP performance demonstrates that the two are not closely related.

China stock market



China GDP



Exogenous shocks

Investors will always attempt to forecast the likely risks that could impact their portfolios. While investors can do their best to protect against known risks, the risk of an exogenous shock or an otherwise unforeseeable or unpredictable one will have a significant impact on your portfolio. The most effective way to protect against exogenous shocks is to avoid having too much exposure to a single market factor. Good portfolio diversification is essentially the same as the old adage of not keeping all of one's eggs in the same basket. Ideally, portfolio diversification brings with it lots of different types of eggs in different baskets. The paradox of diversification, however, is that too much is not necessarily beneficial; rather, a *prudent* level of genuine diversification within a portfolio will help to reduce its sensitivity to exogenous shocks. The other important characteristic of genuine diversification is that it must be managed dynamically because the relationships between different asset classes change through time and as a result so does diversification.

Buying something you don't understand

Finally, and crucially, it is important to never buy something that you do not understand. This is a significant potential risk and one that many investors take too lightly. Generally speaking, if the historical returns profile looks too good to be true, then it may well be.

Data source: Bloomberg, October 2012

Conclusion

Investing is both an exciting and potentially rewarding undertaking. It also can be the cause of much anxiety as volatility rises. A well managed and well diversified portfolio should be positioned to ride out the short term noise. The real risks for investors are losing money that cannot be earned back, or not earning a sufficient return to provide for a reasonable retirement. Investing can be complex and confusing and Momentum GIM is determined to provide simple multi asset solutions that provide attractive investment returns on a through the cycle basis. When creating portfolios we seek to avoid the above risks as we believe that long term returns will benefit from such an approach. Portfolios must be dynamically managed, as today's sources of risks can be tomorrow's sources of opportunity. We believe that maintaining a focused, valuation-driven investment approach enables us to look past the short term noise that characterises today's markets, and to act as genuine investors rather than speculators on behalf of our investors.

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