

LEARNING TO LOVE RISK

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Traditional thinking is that risk in investment is something to be avoided. In this article we dispel this idea and suggest that risk, far from being a bad thing, is something that investors should embrace. After all, with risk comes reward, and by avoiding some common pitfalls we believe investors can learn to love risk.

“The average long-term experience in investing is never surprising, but the short term experience is always surprising. We now know to focus not on rate of return, but on the informed management of risk.”

Charles Ellis, Investment Policy, 1985

What is risk?

“In investing, what is comfortable is rarely profitable.” (Robert Arnott)

The Oxford English dictionary defines risk thus:

noun **1** a situation involving exposure to danger. **2** the possibility that something unpleasant will happen. **3** a person or thing causing a risk or regarded in relation to risk: a fire risk.

In investment terms, risk is most commonly defined as standard deviation – a measure of volatility, or the extent to which the value of an investment will fluctuate. However, most investors are only concerned with downside volatility – the “risk” that an investment’s volatility may lead to higher than average returns is not generally a concern! It is for this reason that standard deviation alone is not a sufficient definition of risk.

The main risk which investors should be mindful of is that of failing to achieve one’s financial objectives. For most people the accumulation of wealth is not an end in itself – the primary aim is to accumulate sufficient wealth such that a desired lifestyle can be achieved without running out of money.

Smart ideas about wealth

The Risk of not sticking to the Plan!

"The investor's chief problem – and even his worst enemy – is likely to be himself." (Graham Benjamin 1894-1976, Security Analysis 1934)

Academic research provides overwhelming evidence that the asset allocation decision (i.e. the split between bonds and equities) is the main determinant of returns. However, accepting this truth is one thing – sticking to it through good times and bad is quite another. Research shows that risk averse investors are more likely to abandon the discipline of an asset allocation policy when risk actually rears its ugly head. Therefore in determining returns, the ability to stick to the asset allocation originally selected is perhaps the most important factor.

The seemingly impossible can happen

"Chance favours the prepared mind." (Louis Pasteur 1822-1895)

Investors need to accept that the unthinkable might happen. Just because something is highly unlikely does not make it impossible – September 11th 2001 proved that. Learning to accept the potential for significant negative surprises is an important lesson in learning to love risk.

Time, not timing, is your friend

"Market timing is a wicked idea. Don't try it – ever." (Charles D Ellis, Winning the Loser's Game 1985)

It is widely accepted that equities provide higher returns than bonds *over the long term*. They do so because investors demand a higher return as compensation for the greater risk inherent in owning equities. However, there's a reason why this is known as the "equity *risk* premium" and not simply the "equity premium". The word "risk" is there for a very good reason – there will always be periods of time when equities will underperform bonds. Bear markets generally occur once every 3 or 4 years. Anyone investing in equities must accept that risk. The risk for investors when this happens is not the fact that equities have fallen in value, it is that if they panic and abandon equities during these periods, they will almost certainly miss the upturn when it eventually occurs.

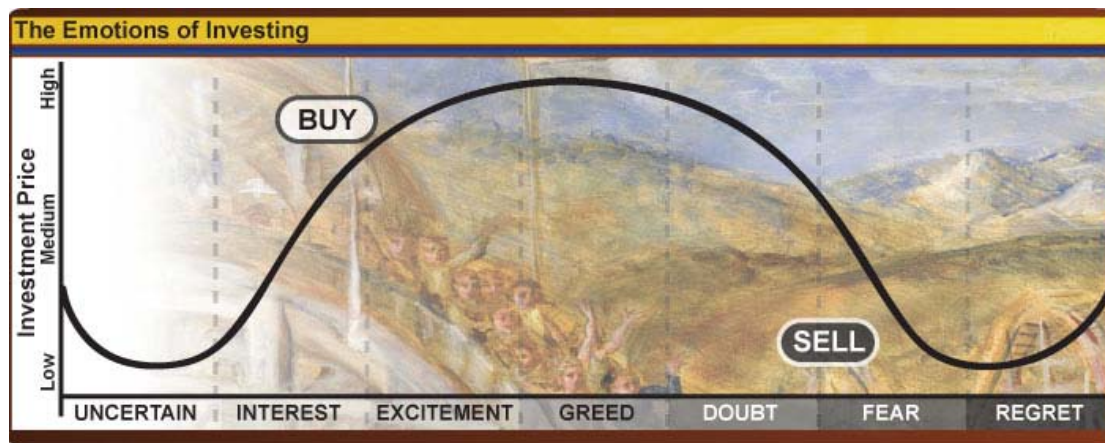
The focussed investor, sticking to his asset allocation strategy will remain invested and ride out the storm. The discipline of maintaining the original asset allocation through good times and bad will also ensure that profits are taken as they occur, and the "buy low, sell high" strategy which maintaining the asset allocation entails will pay dividends in the long run.

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Learn to ignore the “noise”

“Speculation is an effort, probably unsuccessful, to turn a little money into a lot. Investment is an effort, which should be successful, to prevent a lot of money from becoming a little.” (Fred Schwed Jr, *Where are the Customers’ Yachts?* 1940)

“Stockmarkets are currently uncertain” is a phrase which is often bandied about by market commentators. Whenever you hear this remember you are merely being told something that you already know. Markets are *always* uncertain because if they were not the returns would be less, and if returns were less then companies would be starved of capital as capital flowed into ‘safe’ cash and index linked bonds.



Source: *Index Funds: The 12-step Program for Active Investors*

William Bernstein in his book *The Intelligent Asset Allocator* probably summed it up best:

“There are two kinds of investors, be they large or small: those who don’t know where the market is headed and those who don’t know that they don’t know. Then again, there is a third type of investor – the investment professional, who indeed knows that he or she doesn’t know, but whose livelihood depends upon appearing to know.”

Risk and Expected return

“Investing is a strange business. It’s the only one we know of where the more expensive the products get, the more customers want to buy them.” (Anthony M Gailea/William Patalon III, *Blue Chip Books/Contrarian Investing*)

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Every investor understands the basic nature of risk and reward. In order to attract investors to take more risk, equities must offer a higher expected return – note it's an *expected* return, not a guaranteed return. If higher returns were guaranteed there would be no risk. The risk is that those expected returns may not materialise. Companies do make bad management decisions; sometimes companies do act fraudulently; sometimes companies do go bust.

The greater the risk, the higher the expected return and the lower the price we expect to pay, and vice versa. It is worth remembering that spectacular returns will only occur when prices are at very low levels – i.e. when most investors are afraid to invest. Only bold and disciplined investors benefit (i.e. those who follow a disciplined asset allocation policy, who will be buying equities when prices are low).

Conversely, there is a limit to how low the equity risk premium can fall – the benchmark generally being the risk free rate available from short dated government bonds; however this does not mean that prices will not temporarily rise above that level. Greed and irrationality will sometimes drive the herd. This is known as a “bubble”. Disciplined investors will not get caught up in this “irrational over exuberance” as their asset allocation strategy will force them to take profits, sell highly priced assets (in this scenario equities) and buy lower priced assets (bonds). This counter-intuitive behaviour will be what protects them when the bubble bursts. Bear markets restore equity risk premiums.

Choose your “trusted adviser” with care

*“It's not easy to get rich in Las Vegas, at Churchill Downs or at the local Merrill Lynch office.”
(Paul A Samuelson, Nobel Laureate in Economics, 1970)*

Who do you trust to always tell you the truth? If your investment adviser is not on the list, find a new one. Don't run the risk of failing in your investment objectives by being told only what an adviser thinks you want to hear.

Advisers who place the highest priority on putting their clients' interests first will always be straight with them. These advisers will always tell their clients that neither they nor anyone else know how to beat the market. Rather, they will design a portfolio that will give their client a reasonable chance of achieving their financial goals, based on their current and desired future lifestyle. A good adviser is one who delivers this message regardless of whether or not the client wants to hear it.

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Summary

Recognising that investing in equities comes with a risk attached is the first step in learning to love risk. The prudent investor plans for that risk. Prudent investors know that history teaches us that just because an event has not *yet* occurred does not mean that it cannot, or will not occur in the future. Prudent investors build an investment plan that allocates their capital to equities and bonds in a manner that takes into account not only their time horizon but their investment objectives, the cost of those objectives, the stability of their earned and unearned income, their willingness to take risk and perhaps most importantly their *need* to take risk.

The prudent investor sticks with their asset allocation strategy regardless of short term market fluctuations. They accept that returns from equities are expected not guaranteed, and they make the equity risk premium work in their favour by buying low and selling high. They ignore “financial porn” and employ trusted advisers to help them to stick to the strategy they know gives them a reasonable chance of achieving their financial goals and capturing the returns from capital markets which are there for the taking.

With these principles in mind the prudent investor has nothing to fear from risk, or as Evil Knievel said *“Risk is good. Not properly managing your risk is a dangerous leap.”*

Quotations sourced from ‘Index Funds: The 12-step Program for Active Investors’ by Mark T Hebner

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