TOWN CLOSE
Financial Planning

Investment risk

future proofing your finances

INVESTMENT RISK

This is one of a series of one/two pagers covering various aspects of investing. The others are "Strategy", "Diversification" and "Expectations".

Risk is a devilishly slippery and complex concept. One man's risky is another's risk-less. And, of course, what's risky today may not be tomorrow. It's always a matter of context.

I like Elroy Dimson's thought: *"Risk means more things can happen than will happen."*

And Howard Marks' inversion: *"Even though many things can happen, only one will."*

What is risk?

There are many forms of risk, here are a few that Howard Marks identified: upside, inflation, interest rates, events, black swans, model, basis, concentration, over-diversification, credit, illiquidity, funding, gearing, falling short and - these days - FOMO.

These risks, and most of the articles or books on risk, relate to investment risk – i.e., what affects the value of investments over time.

However, for us, the investments are the servant of your financial plan, not the other way around. It's the financial plan that determines what and how much investment risk should be taken on.

Therefore we should add some specific planning risks; namely the risk you outlive your money and the risk you pose to yourself in panic situations.

All the risks above can be aggregated under one risk heading, which Howard Marks in "Risk Revisited Again" states as follows: *"What they (investors) fear most is the possibility of permanent loss."*

Risk is permanent loss, with the emphasis on "permanent". We agree wholeheartedly.

Warren Buffet, in his 2017 Letter to Shareholders, thinks more in terms of falling short: *"Investing is an activity in which consumption today is foregone in an attempt to allow greater consumption at a later date. "Risk" is the possibility that this objective won't be attained."*

Volatility

Neither description mentions "volatility", the amount by which investments go up and down, which is curious.

Volatility is loved by regulators and the press. It is, de facto, the officially approved measurement of risk. As a result its influence on just about everything in the investment world is extensive and probably corrosive. Concentrating on the wrong thing usually is.

Volatility is convenient which is why it is usually (mis)used to define risk. It can be measured; a number can be put to it. Numbers are essential to the maths, formulas and models that support much of what the investment industry does. So, you see, there has to be a number.

This ignores the fact that volatility only becomes a risk when you react to it in the wrong way; it's benign until that point.

Which means that focussing on volatility is a mistake, it draws attention away from the elephant in the room – permanent loss.

The mistake is compounded by many who think that, by dealing with volatility, they have dealt with risk. They haven't. Low volatile, benign investments can, and do, go to zero.

For example, bonds are less volatile than equities most of the time but that doesn't make them less risky most of the time. But a "low risk" investor will, most likely, have a large holding in bonds.

That's as guided by her adviser's compliance department, which is interpreting the regulator's vague wishes, which are necessarily vague to allow the wriggle room needed to ensure they are never to blame. And all this as a result of a simple misunderstanding.

And what does Warren Buffet think of that? *"It is a terrible mistake for investors with long term hori ons .to measure their investment "risk" by their portfolio's ratio of bonds to stocks e uities . ften high grade bonds in an investment portfolio increase its risk."*

Although bonds do, in the main, reduce volatility. But, as Howard Marks says: *" e can ride out volatility but we never get a chance to undo a permanent loss."*

Permanent loss
So, we start our work by focussing on permanent loss of capital, not volatility, as the major risk to our clients.

But there's an immediate issue, there's no number. Or, as Howard Marks points out:

" he probability of loss is no more measurable than the probability of rain. It can be modelled and it can be estimated but it cannot be known."

That's the opposite to volatility. Incorrect certainty is better than no certainty apparently, and numbers are certain. But, as Carveth Read put it: *"It is better to be vaguely right than e actly wrong."*

Forecasts
The probability of loss can't be known because future outcomes are unknowable, which makes forecasts worthless. And that's ignoring the fact there is no consistency amongst forecasters (everyone is right sooner or later, no-one is always right) and, at any given moment, just about every outcome has been forecast to happen.

And, even when the consensus forecast is X, it may not be the most probable one or the one that happens. In hanging our hat on consensus forecasts, we run the risk of ignoring improbable outcomes.

These are all really important points to take on board and acknowledge. When we do, we can recognise our limitations and accommodate them, rather than blindly acting on forecasts purporting to confirm the future.

If you ever read or hear about someone who's convinced the future is known, bear in mind this from John Kenneth Galbraith: *"We have two classes of forecasters:Those who don't know– and those who don't know they don't know."*

Of course, all forecasters know they don't know, it's evident in their actions. If they really had faith in their abilities, they'd back their foresight to the hilt every time. And they'd borrow money to get even great exposure to what they know will happen.

But they don't; it's their tacit acknowledgement that their forecasts aren't worth backing.

How permanent loss happens
One of two ways: "An otherwise temporary dip is locked in when the investor sells during a downswing…….or the investment itself is unable to recover for fundamental reasons." Howard Marks.

I'd mention inflation, which is the permanent loss of purchasing power. And that we can help with both inflation and your behaviour. We can help you keep calm and not panic, but we can't stop you ignoring us.

In that context, 90% (or more) of the fee we earn is directly linked to helping you "behave" on a variety of fronts. Avoiding blind panic being a big one.

How to handle "risk"
We know we can't avoid all risk, but we can have a good go at controlling it.

It comes down to sticking to the plan which was formulated from the goals we agreed, where the investment strategy is the servant of the plan (and not the other way around).

The first step is to focus on minimising the permanent loss of capital, not minimising volatility. To this end we use regulated, liquid investment vehicles that have a good spread of holdings.

Or, put another way, we avoid betting on individual shares and never get involved with anything not regulated, or that invests in illiquid assets like property.

We believe that means none of the components of your investment strategy has the least chance of going to zero or being accessible. Those are two big ticks.

The second part is to help you "behave", as mentioned above. We want both your finances and psyches to withstand significant and prolonged downturns. The best way of doing that is to make sure you have enough in reserve to cover you when the downturns happen.

Our starting position is that your next three years' expected expenditure should be covered by known income and cash. By covering your liabilities in this way I believe you should be able to withstand the inevitable periods of volatility.

And that's very important because of the third prong of our approach which is to avoid inflation causing you a permanent loss of capital. That means investing mainly in equities. Only equities have, on average, produced the inflation-beating returns you need. The trouble is they are usually quite volatile, hence the buffer outlined above which will allow you to "survive" drops when they come.

Typically we'd expect you to be invested 80% in equities and 20% in bonds. That will change as we move through the cycle from unsustainable euphoria to abject despair and back again. As we reach those extremes, we can move money to take advantage of the backswings towards the happy medium.

The real problem?
Not knowing the future can be an issue, especially for those hell-bent on having the sort of answer only numbers can provide.

It would seem that having an answer is often more important than not, regardless of the usefulness of the answer.

But, if you're misled by the answer, you're likely to take actions you'll regret in the end. And that increases the chances you suffer permanent losses you can't afford. And a supposedly risk-reducing action has become a risk-increasing folly.

That's the real problem, not being able to quantify something is not. Therefore, we eschew the answers volatility figures provide and accept we don't know the future. And are rational enough to admit both.

But that still leaves us with Howard Marks' conundrum: *"…investing requires us to decide how to position a portfolio for future developments, but the future isn't knowable."*

In summary

- Risk exists but isn't what you think it is.
- We can't measure risk, because the future isn't knowable.
- We can take sensible measures to control risk as we understand it to be.
- And thereby remove a decent amount of uncertainty.
- But we can't avoid risk.
- We can be alert to unsustainable euphoria and abject despair and, hopefully, take advantage of both.
- And avoid being drawn in to harmful actions predicated on unhelpful answers.

With thanks, throughout, to Howard Marks, Nick Murray, Peter Bernstein and a host of other far-sighted and insightful professionals who have shared their wisdom over the years.