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STUART + CARLYON

Financial advisers for your lifetime goals

Reflecting on risk

Now you can imagine that after 20 or 30 years in the profession, any conference runs the risk of treading over familiar ground. Not so the recent Portfolio Construction Conference in Sydney which had in attendance more than 500 colleagues mostly from Australia and had a great line up of speakers. The theme: risk and return.

“When talking about risks, anxiety levels do rise. Our take is that you should prepare yourself for worst case scenarios and build robust portfolios that deliver income and participate in parts of the world that are growing.”

The theme is very timely because there is a palpable sense that the world is less stable than it was 10 years ago. It was fascinating to hear from speakers who are experts in geopolitical issues rather than simply finance. We got to hear deep insights about the situations in the Middle East, the Ukraine and south-east Asia. To be honest, we did not emerge particularly comforted by what we heard.

Marko Papic, the Chief Geopolitical Strategist from BCA Research in Montreal focused on the Middle East and voiced his opinion that global multi-polarity (USA, China, Russia,) increases the frequency and magnitude of risks. Life was more certain when the cold war was a two-way stand-off.

The US role in global affairs is reducing for fiscal, political and strategic reasons, while the growing power and wealth of many developing countries could make the world a less stable place especially when these countries are not subscribers to democracy.

Another political specialist is Linda Jakobson who spoke on China's foreign policy, focusing on the territorial disputes in the seas of Japan and Vietnam where China is asserting itself. Through its investments and powerful leverage China clearly wants to be a dominant force in East Asia.

An interesting question came from the floor during one session: why should investors worry about geopolitical issues? Shouldn't we be more concerned with things at a market or company level? After all, to date the Ukraine standoff and continuing Middle East tensions have not been too detrimental on markets. Companies are still making goods that people have to buy.

Yet speakers drew the lines that connect foreign political events back to our investments – reminding us that much of the political instability is linked to the world's oil and energy markets, world commodity prices and to the question of whether our trading partners will share our respect for democracy and fair trading.

When talking about risks, anxiety levels do rise. Our take is that you should prepare yourself for worst case scenarios and build robust portfolios that deliver income and participate in parts of the world that are growing. Emerging markets funds have picked up recently as the developed markets remain expensive.

Consensus: we're heading for another correction

Love that word 'correction.' Normally it implies the merest pencil mark that highlights a picky minor quibble in an otherwise fine piece of work. But when applied to the share market or the global economy the word seems imbued with enough seismic power to spark off an economic tsunami warning. A *correction*? How big?

“The Global Financial Crisis got rid of poor performing companies. We always need corrections to clean out the excess.”

At the conference a definite theme was how markets have risen strongly since the lows of March 2009 (post GFC), with unemployment rates dropping. With the US Federal Reserve still pumping money into the system to keep rates low enough to facilitate business, the question arises: what happens when they stop?

Most speakers at the Portfolio Construction Conference agreed we don't have a market bubble yet. And most prefer to be invested in shares even if they are becoming more expensive – better than low interest rates. But the diverse roster of speakers each saw a correction on the horizon.

Summed up one analyst: "The Global Financial Crisis got rid of poor performing companies. We always need corrections to clean out the excess." Remember that corrections are a normal part of investment cycles.

Reconnecting risk and return

Here's a riddle. The steady recovery in share markets over the past three years has resulted in high returns and unnaturally low volatility. In investment terms, very few ups and downs equals low risk. That's good isn't it?

Well, here's the disconnect. Despite the steady returns the markets are expressing a *lack of confidence*. Why is this?

If political events worldwide have some rational influence on the investment markets, they also have indirect effects more to do with our human psychology than to do with the events in question.

Pick up any newspaper and according to the front page the world is going to hell in a hand basket. Doomed airliners, horrific crimes, business catastrophes: the media focus is always on risk - from the GFC gloomy headlines to the present day where the investment returns have been great, but the headlines are likely to ask: "yes, but when will markets fall again?"

Online commentators are rewarded by the number of clicks onto their website: they are effectively paid to get your attention. That's why there are so many articles with titles such as: "Seven reasons why the banking system is heading for collapse!"

Markets, made up of individual news-reading investors, are affected by all this noise – because we are wired, for better or worse, to respond to signals in not strictly rational ways.

Three common biases include:

- Availability bias: making judgements about the probability of events based on how easy it is to think of examples.
- Recency bias : evaluating performance based on the perspective of recent events.
- Loss aversion: strongly preferring avoiding losses to acquiring gains.

These three biases combine to have a pronounced effect in a world where short-term headlines dominate our understanding of world events.

Think long-term, and focus on the things under your control

The increased short term focus of investors creates a mis-alignment with a long term investment horizon. By succumbing to our biases we are exposing ourselves to the risk of running out of money sooner than we ought.

Whichever category of investor you are (we tend to fall into one of three types) we still have a need for a long term focus.

- Accumulators – saving for retirement. A 40+ year planning horizon.
- De-cumulators – retired and living off (and preserving) capital over a 25-30 years span.
- Transferors – passing on wealth. A 40+ year planning horizon.

So where are the risks we need to worry about most? Our starting point for designing strategies is consideration of three fundamental client risks.

1. Consistency: "The investment income may fluctuate but my bills don't."
2. Sustainability: "I don't want my money to run out."
3. Flexibility: "I need to adjust to my changing circumstances."

In other words don't think of risk in terms of share prices, interest rates and sudden currency fluctuations - over which you actually have no control - but rather what could happen in your own situation and what you can do.

Plan B and the radio: two ways to achieve peace of mind.

Next, work out a contingency plan. Should your expected retirement outcome not pan-out, due to health or wealth changes, it's far better to have thought ahead so you have options. For example selling the house and downsizing, or perhaps taking in boarders? Or would it be possible to join the workforce again? And how about prioritising expenditure or turning the lawn into a vege garden?

If it comes to it, we can often easily manage changing circumstances. Having that Plan B reduces anxiety and allows you to invest long term which is crucial.

In our work we get to see bad risks (of disability perhaps) but also very good risks! One of the biggest of these risks we see is longevity. Our clients are living longer than they expected, and more actively. So the investment strategy definitely needs a long term focus.

We can do the numbers for a pessimistic outcome; whether your money will last if returns don't turn out as well as expected. That's your investment risk capacity: the bottom line, if you like.

If you also weigh up risk by what you can control yourself, then the retirement journey will be a comfortable one.

Peace of mind. The first lesson is to go easy on the headline news. Turn off the talkback radio! Put yourself on a media diet. We need to distinguish between general market noise and relevant investment signals – and the first step is to reduce the clamour.