

### Manage the Risk and the Money!

#### An alternative way of looking at investment

by

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Investors in equity markets have, on the whole, enjoyed strong returns since March of 2003 as prices have recovered from the vicious “Bear” market which began in 2000. Some market commentators believe this recovery is merely a pause in a longer term decline, not an investment view we share, but nonetheless markets will not continue to rise at the rate enjoyed since 2003 indefinitely. The painful lessons drawn from the “Bear” market are valuable ones and should not be forgotten.

It’s a scenario that unfortunately becomes all too familiar to many investors when “Bull” markets, especially in equities, finally run out of steam or pull back during a consolidation phase.

A smiling investment manager explains that “relative to the benchmark” your growth or balanced portfolio has out-performed by 5%. The dilemma is, the benchmark is negative and is in double digits! This scenario may well arise simply because, whilst a benchmark had been agreed, the responsibility for adjusting the benchmark to reflect market or economic conditions was not addressed. Consequently the investment manager might argue that their objective, performance over and above the agreed benchmark, has been met even though the portfolio has fallen in value.

This scenario is best avoided by concentrating not on how the assets will be managed but on how “Risk” is to be managed. In this way, the investment manager becomes focused not solely on maximising return relative to a single or combination of set indices

(usually by marginally overweighting or underweighting certain components of those indices) but is immediately aligned with the goals of the investor. That is to say to maximise return but within the confines of an acceptable level of risk.

Using quantitative data on volatility and historic and forecast returns, it is possible to manage portfolios across a broad spectrum of asset classes to a pre-defined “risk level” using Value at Risk calculations. Thus investors can indicate what level of capital they are prepared to put at risk of loss and the manager can provide an indication of the return the investor might expect for that given level of risk.

Such portfolios are managed in a way which is totally independent of benchmark considerations.

As with any investment mandate the most important first step is to understand the client, their requirements and investment experience. Within the context of these particular mandates, it is imperative that the level of risk the client is prepared to adopt is fully understood, not only by the investment manager but also by the client themselves. Having had such conversations and using “stress testing” models to show the effect on portfolios of events such as Black Monday, the Tech Crash or the Russian Debt Crisis of 1998 it is interesting to note that, in many instances, client perception of acceptable risk at the asset allocation level changes once they better understand the potential effect of the implied volatility of different asset classes.

When investing using a risk based approach diversification across asset classes is imperative, as is the need to manage the mandate actively as short term volatility and Value at Risk can change. Diversification is important because “risk” can be reduced within portfolios by ensuring that different types of investments are utilised which, historically, have shown low levels of correlation with one another in negative markets. Asset classes will likely include equities, bonds, real estate, commodities and hedge funds but may not exclude for instance, structured notes. Our own approach utilises exchange traded funds, index trackers, third party and proprietary funds rather than individual equity or fixed income positions, which in themselves bring further risk benefits via diversification.

Exposure is “long only”, although potential downside movements are on occasions hedged or protected via option strategies should, for instance, equity market valuations be perceived as too high. Given the way in which such portfolios are constructed it is fair to say that they are unlikely to demonstrate performance over and above equities in strongly rising markets however, equally in falling markets the Value at Risk discipline will assist in managing the potential for downside.

This “Unconstrained” portfolio concept, as it is referred to at Deutsche Bank, might sound complicated to some, but really it’s not. It’s like going shopping.

On offer within the store is a wide array of different asset classes. You have a budget, in this case that budget is measured as “Risk”, and like every good shopper, one tries to get the best value for money. Here that means the best possible return for your risk budget.

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Ends.

#### Notes for Editors

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