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Building a portfolio (2)

What Is Your Attitude to Investment Risk

The first stage in building a portfolio is to think through what is suitable for you. You must take into account all of your circumstances and objectives. The most difficult is matching the investment to your attitude to risk, and that is what we focus on here. You must have a clear plan. Ask yourself questions about your attitude to risk and inform yourself about investment risk. But you must also understand how things can go wrong...

The decision as to whether an investment is suitable for you must take into account all of your circumstances and objectives. In particular:

- the timescale for investment
- whether the objective is income or growth
- your age.

The most difficult is matching the investment to your attitude to risk.

What is risk?

A good place to start is a definition. From the point of view of a private investor "risk"   is the possibility of incurring a loss, which is what is feared most.

Here we use the term "risk" to denote the volatility of a fund, that is the extent to which, and speed with which, it might go down as well as up.

This is for two reasons:

- because sharp falls might panic the investor into selling, and thereby realising the loss which they fear most
- because most retail investors are concerned about "the journey", and want to achieve a given return with the least possible volatility (risk)

We typically refer to "monthly risk". For example the "monthly risk" figure for a typical UK stockmarket fund is about 8%. This roughly means that in 19 months out of 20 you should not expect a fall in the capital value of more than 8% in any one month.

We're not good at investing!

Far too many investors jump straight into buying investments without considering if risk investments are right for them.

One commentator said **"Human beings are not cut out to be natural investors"**, and this is an uncomfortable truth for many of us. Millions of years of evolution have given us a brain that can instantly process visual images, assess threats, develop language and (sometimes?) make informed choices given sufficient information.

But **millions of years of evolution have not enabled the development of the ability to invest rationally.** Some say this is because financial markets are a relatively new hunting ground, and given another few hundred thousand years we might do better.

Others say it's because our unconscious impulse to herd means that if everyone else is buying we want to as well - once in a crowd an ordinarily rational person tends to irrationality (which is why we get investment bubbles). The latter is certainly what we have observed over many years.

So lets have a clear plan

Whatever the reason, because of our inherent inability to invest rationally, **it is vital that we construct (in one of our rational moments) a sound framework or plan,** within which we deal with risk investments from year to year and a big part of that plan must be understanding with what level of risk you are comfortable.

But before considering risk in more detail, it is important to remind ourselves that the stockmarket does offer the opportunity for superb long term rewards. You must understand that these rewards are available because you take on risk - risk and reward go hand in hand.

What risk are you comfortable with?

There is no perfect way to assess this. Asking this question of yourself in a void (without also having some understanding of investment risk and history) is of limited or no value. A sensible way to proceed would be:

1 ask yourself questions about your attitude to risk
2 inform yourself about investment risk
3 understand investment risk attaching to funds

And at the end re-check your answer to 1, as you may feel more or less happy about risk having gone through the whole process, and with the benefit of a greater understanding.

Ask yourself questions about your attitude to risk

Imagine you invested £10,000 just 6 months ago. There is some unexpected news, and the stockmarket, and the value of your fund falls to £7,000, down 30%. How would you feel?

- would it cause you grave concern and worry? Or …
- would you be relatively relaxed, because you are comfortable continuing to take at least a 5 year view?

Even if relatively well off, with secure income, such falls may still give you sleepless nights – how you might react is a very personal matter.

"My funds have fallen 30%!"

If this would be a shock you would rather not experience, sell or reduce your risk investments. It might mean you miss out on a continuing recovery – or that you don't suffer further sharp losses, but that isn't the point. Whether you should remain invested is about you and your attitudes, not about markets. You need to make a hard-nosed decision about whether you can cope with risk investments, and crystallising losses should be regarded as the price of experience.

The stockmarkets can and do play games with your mind, in particular with the powerful emotions of fear and greed. Some investors may just need assistance to think a little more rationally.

Is this you?

For example, do you have secure income, more than enough on deposit for peace of mind, and no debts? Just re-affirming this will help many stop worrying. But if, despite this high level of personal financial security, you still can't sleep at night with the possibility of your investments falling sharply, you should sell, whatever you might think about the stockmarket and its potential.

More questions

This is a very basic approach to figuring the level of risk with which you are comfortable, and there are more formal approaches for testing your risk tolerance, which would ask questions such as:

- do you think of risk as uncertainty or opportunity?
- are you more concerned about possible gains than possible losses?
- when things have gone wrong financially in the past have you adapted easily or uneasily? have you looked for someone to blame?

If you would like to go through a more formal risk tolerance test, do get in touch, and we will let you know the details and cost.

Inform yourself about investment risk

Past performance is not a guide to future performance. But history is a good place to start to explore how well different asset classes have performed over long periods, and what can go wrong. You can see in the table at the top of the next page how, providing you take a sufficiently long view, the probability of equities or shares providing better returns than bonds or leaving the money on deposit is very high. These figures are based on analysis of the stockmarket from 1899 by Barclays Capital (2011).

Over longer periods a key issue is whether the returns from any of these asset classes also beat inflation. The Barclays Equity Gilt Study considered every 10 year rolling period since 1899. Equities did better than inflation 87% of the time, gilts 79%, and cash 90%.

So the case for investing in the stockmarket is clearly compelling.

But you must also understand how things can go wrong

Contrary to the perception of many that were new to investment in the decade up to 2000, stockmarkets go down as well as up; the bear market of 2000/2003 being a rude re-awakening, reinforced in the Autumn of 2008. From 1918 to 1977 you would commonly have seen one year in three with the stockmarket declining, falls of 20-30% being commonplace.

The bear markets of 2000-2003 and 2008-2009 were perhaps a reminder that the volatility prior to 1977 was the norm. But through all of these ups and downs the long term trend remained up, you just needed patience.

The ***average*** downturn (bear market) in the US stockmarket since 1875 has produced a fall of 32% from peak to trough, and lasted 18 months. Patience got you through the ***average*** downturn.

You could feel quite unlucky having lived over the last 10 years. Yet it has not been as bad as some analysis would have you believe.

For example, over the last 10 years the FTSE All Share Index is up 18.95%, compared to a 90 day deposit return of 32% (according to Moneyfacts).

But this is distorted. If dividends were re-invested the index was up 68%. Not so bad, and it could have been worse. And it was a considerably better outcome for investors that bought some of the most popular stock market-linked funds e.g. ***Invesco Perpetual Income*** was up 137%.

You could be this unlucky - the accidents of history

You can easily factor into your thinking occasional years of weakness such as just described, as these can be dealt with by patience and a sensible timeframe for investment. But very occasionally, perhaps once every few decades, it can get somewhat worse.

In real terms (that is after allowing for inflation) the US stockmarket peak of 1929 was not regained until 1954 (25 years), and the peak of 1966 was not exceeded in real terms until 1995 (29 years).

We call these “accidents of history” (what Nassim Taleb has more recently called “black swans”). If you had invested in 1970 could you really have envisaged that oil prices would quadruple in the years just after? No. Nor could some of our parents and grandparents have guessed that their lives would be consumed by two World Wars and a depression. **Sometimes fate is just going to deal you a tough hand.**

Put together with what occurred in markets in 2008, this is all quite scary. **But context is required**. For example, after the 1929 peak the trough for the US stock market was in 1932, a bear market of just 3 years. With 1999/2000

being the all-time peak for most stock markets, it can be argued that this downturn has already lasted 12 years.

That being the case, **are we more likely to be in the middle or nearer the end of this downturn?**
Fingers crossed it is the latter. But we must acknowledge some research that tells us long term, secular, bear markets last an average of 16 years - this fact alone should ensure that we continue to take care for a little while yet.

To provide balance, it must also be made clear that stock market investment has provided superb returns over long periods.

the rewards - they're very significant
For example, £100 invested in the stock market in 1945 has grown to £136,107, with dividends reinvested (*Source:Barclays Capital, 2011*). If you had alternatively invested into gilts or left your money on deposit the comparative values would be just £5,565 or £6,163 respectively.

In part 3 we will look at the importance of asset allocation and how your age should influence the spread of risk within your portfolio.