Risk and risky considerations

Market corrections and rebounds often prompt investors to rethink their allocation toward risky assets within their investment portfolios. While rebalancing a portfolio due to extreme market movements may seem like an intuitive decision, it is more often than not borne out of the fear that the market has entered a new bear or bull phase. This type of drastic behaviour results in a hasty move to more conservative asset classes and conversely a mis-timed entry into an already established equity rally.

Essentially these corrections or rebounds (more commonly known as volatility and measured by standard deviation) are driving the short-term decisions of (emotional) investors. Standard deviation essentially measures the variability around the average (or mean) return. The danger of focussing on a single risk metric such as standard deviation, is that it is easy to lose sight of your initial investment objective, which may be to achieve a certain desired return. In this case, the erratic behaviour (or volatility) of a particular asset class over say, the next three months should be inconsequentional to an investor planning to retire in 20 years' time. In addition, standard deviation records positive deviations away from the mean as being an unfavourble outcome.

The inherent nature of investing forces investors to introduce risk into a portfolio as return and risk are concepts that are intrinsically inseparable. However, standard deviation is not the only way in which we can define risk. An alternative method of looking at risk is to evaluate downside deviation. Downside deviation serves to correct some of the shortcomings of the standard deviation measure. It shows the deviation of returns below a certain threshold (zero if an absolute return is required) and does not discount positive deviations from the mean or minimum acceptable return as being a bad outcome.

The failure to achieve a particular investment return could also be viewed as a risk. Often investors position their portfolios too conservatively, resulting in negative real returns in the long term and a retirement nest egg that will not sustain the lifestyle that the investor has become accustomed to. The mere fact that people are living for up to 20 years or more during retirement is testament to the fact that there is a danger of not taking enough risk.

Investors drawing an income from their investments may experience increased volatility in their portfolios as a particularly bad month in the market coupled with a regular monthly withdrawal will lead to a depletion of capital. The low base created by this monthly depletion is in itself a risk. Investors who are able to limit the drawdown in their portfolios by investing in superior funds that protect capital on the downside are in a markedly better position to compound those returns once markets re-rate.

While risk is an important consideration when making an investment decision, it should be quantified within the context of the investment. In addition the tolerance of risk should be considered not only in conjuction with investor psychology, but also with the investment time horizon.