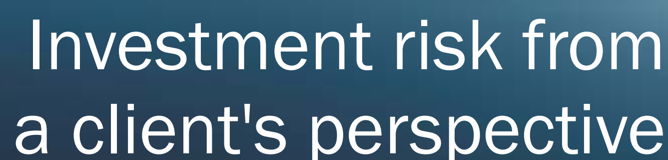

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Risk means different things to different people and to make the most appropriate investment decision for a client, risk must be defined clearly and measured correctly. When it comes to outcome based investing, risk must be understood in terms of the client's risk tolerance and the goals that they want to achieve.

But what is a risk in the context of investments? Investment risk is traditionally defined as volatility, or the average variation in price changes of investments. We suppose that the more variable a return is expected to be, the less confident we are about the outcome. And whilst volatility is useful to describe risk for investment professionals, investors saving for a specific goal do not think in these narrowly defined mathematical terms. Investors tend to think of risk as the prospect of an undesirable outcome, such as a financial loss or not meeting an investment objective. These differences in perceived risk measures, the need for a defined understanding of client risk and integrating this into the appropriate management of investment portfolios are important to understand.

Traditional investment risk measures

Volatility is probably the most well known and widely used risk measure in the investment world. It measures the fluctuation of a stream of historical returns relative to the historical average of the returns. Even though it does give you a lot of information about the behaviour of a specific instrument, it is fairly difficult to relate to and make sense of the number if you have a specific forward looking goal in mind.

Volatility also conflates the outperformance of an expected return with its risk, whereas investors are more concerned with underperformance relative to an expectation. In other words, investors are worried about the downside, not the upside – but volatility sees both of these as equally important sources of risk.

Tracking error as risk measurement

Another commonly used risk measure is tracking error. This measures the deviation away from a predefined benchmark, that is, by how much the return stream differs from the target it is measured against. In some ways this measure is poorly named – it suggests that the bigger the number the bigger the mistake. Often, however, the deviations away from the benchmark are deliberate and therefore not an error, but rather a way of adding potential value. The biggest shortcoming of tracking error as a risk measure is that it does not distinguish between 'bad' tracking error and 'good' tracking error. In other words, if a return stream is constantly ahead of the target it is measured against, and by a fair margin, tracking error will be high, whereas tracking error will be low if a return stream only marginally underperforms the target constantly. Therefore, it is dangerous to conclude that high tracking error is bad and low tracking error is better.

Other risk-adjusted measures

Maximum drawdowns, Value-At-Risk and other risk-adjusted measures like Sharpe and Sortino ratios are again mathematical risk measures, which are a step in the right direction to answering the true meaning of risk for an investor with a goals based mindset. However, they are still not perfect or at least should not be looked at in isolation. These would only be useful if interpreted in the right way and measured relative to the goal in mind.

In short, all these measures have their specific shortcomings. The output and, more importantly, its understanding, is just as important as the inputs that it is based on. The measurement period also plays an important role in interpreting the outcome.

Outcomes based risk framework

In an outcome based environment, it is extremely important to continually assess and understand the possible effects of country-specific-, currency, liquidity, credit-, sector and company risk to ensure that unforeseen events do not severely affect the path to the goal. Risk management is effectively about ensuring that unforeseen events do not destroy value that has been created or prohibit the client from ultimately achieving their goal.

Clients' goals or investment objectives cannot be formulated if the return requirements and the holistic risk constraints are not properly understood. Most clients do not have a full grasp of what their risk profiles are or what amount of risk is required to deliver on an intended goal. They typically understand and know what they would like to achieve, but seldom understand what it means from a risk perspective to deliver on the goal. It is therefore our duty as investment professionals and advisers to assist clients in making the right investment decisions for their specific needs and to ensure they understand what the risk undertaken can mean in practice.

To effectively measure this, their risk profile needs to be established. This is usually defined on a behavioural basis along three different dimensions illustrated in the diagram below. By understanding the true client risk profile and marrying that to the investment goal, a more informed and aligned investment portfolio can be designed, monitored and steered along the path to successfully deliver on the objective with a high degree of certainty.

www.vanguard.co.uk/documents/portal/literature/investment-risk-guide.pdf

Clients with capital invested in an investment portfolio can and will most likely have a very different definition of risk, especially if capital is invested to deliver on a specified goal. Probabilities of not delivering on the goal, preserving purchasing power of capital and capital losses are much more relevant and tangible in these investors' lives. These risks also change through time as personal circumstances change and therefore should be adapted accordingly, alongside the choice of investment product.

Investment advisors should aim to understand the true risk profile of clients, build these risk profiles into the design and construction of the client portfolios, understanding the sensitivities to real world unforeseen risks and monitoring and managing the risk relative to the desired outcome. This enables the advisor to realistically deliver on their client promise, by ensuring the probability of shortfall relative to the goal or objective is minimised as the client's investment journey is played out.