HFG WEALTH MANAGEMENT

INSIGHT

PERSPECTIVES FOR THE GOAL-FOCUSED INVESTOR

Fall 2021

Fall 2021 – INVESTMENT RISK

By: Henry Pizzutello, Chief Investment Officer

RISK IS NOT A "FOUR LETTER WORD"

When most people talk about their investment winners at cocktail parties, the invariable question that is always asked is "How much did you make?" While it is always gratifying to have a profitable success story, the real question that should be asked is "How much risk did you take?" It is much more important to understand how risky an investment is, yet this question is rarely asked, and even when asked, it is even more rarely answered correctly. The answer to why this occurs so regularly is relatively simple — the determination of risk is very complicated for the average investor. Many people understand what risk is, but have little idea what the components of investment risk are. To add even more complexity, investment risk is constantly changing — both at the individual investment level and at the overall market level.

Given this complexity, how should investors look at their portfolios if risk is such an abstract concept? There have been numerous psychological studies that show people feel monetary losses more intensely than gains, and it has been said that "investors measure return in percentages, but measure losses in dollars". One way to combat this perception is to think of your investments in terms of a "risk budget" rather than a collection of capital assets.

A risk budget will help investors to understand how their portfolio will behave in certain markets, and brings the emotional aspects of investing face to face with the quantitative. A portfolio that is built with risk management as the primary objective will likely provide investors with a better overall portfolio-construction approach. While it may not produce the highest return in any given period, it will help them stick to their investment plan and portfolio allocations through turbulent periods.

A key factor is to understand the difference between risk tolerance and risk capacity. Together, these concepts can help determine the amount of acceptable risk in a portfolio of investments.

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Personal risk tolerance is the amount of risk an investor feels comfortable assuming or the degree of market uncertainty an investor is willing to handle. Essentially, this answers the question of how much an investor is willing to lose in order to achieve the necessary portfolio returns to make their financial plan successful. Of course, nobody ever "wants" to lose money, but it is important to realize that losses will occur along the way — the key is to be able to contain these losses within the personal risk tolerance. Risk tolerance can change over time, influenced by the investor's psychology concerning money and finances, and often varies by age, income, and overall goals.

Risk capacity, on the other hand, refers to the minimum amount of risk an investor must take in order to reach their financial goals. Risk capacity is often decided by an investor's current income and financial resources and can also depend on one's plans for the future.

A significant issue that many investors run into when crafting a risk-based portfolio is not ensuring that their risk tolerance and capacity are in line with each other. When the amount of risk taken (risk capacity) exceeds the level an investor is comfortable taking (risk tolerance), a shortfall can occur and make it difficult to reach future financial goals. On the flip side, when risk tolerance is higher than risk capacity, the investor may be forced to take on undue risk.

Optimal portfolio allocation is created by the calculation of the total risk contributions of each asset and compared to the expected return of the portfolio, AND the investor's personal risk profile. This approach aligns with the philosophy that the best way to achieve your return goals is to focus on risk, not return. Balancing risk and return is essential to building portfolios and financial plans that will help investors achieve long-term goals they can stick with along the way.

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As we have discussed, risk is an extremely important facet of successful investing. With that said, we also believe it is one of the most misunderstood. There are many different ideas and interpretations as to what investment risk actually is. Below are some common misconceptions and how we think about risk from those perspectives.

Assets That Are Increasing Have Less Risk

Investors often believe that there is less risk when an asset is moving higher or in an uptrend. This is a huge misconception, because risk can increase when an asset is going up and down We see this very often in sharply rising market environments, which are characterized by FOMO (fear of missing out) investor behavior. Both directions are extremely important when calculating the risk level of an asset.

Risk should be evaluated during rising and falling periods. This will provide investors a better picture for the asset's risk and allow them to not be caught off guard or become complacent in an up-trending market. It also allows the ability for an investor to take earlier action should a large spike in risk occur.

All Risk Should Be Treated Equally

Many investors view all types of risk through one lens and don't understand how each can impact their portfolio. There are many different types of risk. For example, the loss potential of owning an individual security can be significantly greater than owning all the stocks in its sector. An investor can get the sector right, while being wrong on the stock and significantly negatively impact their portfolio.

We believe risk should be evaluated on multiple levels. Trying to predict what type of risk will be the cause of a loss is virtually impossible. It's important to understand the varying levels of risk exposure within a portfolio and how the assets are correlated to determine the magnitude of the asset's potential loss.

Volatility = Risk

Investors closely monitor the VIX index and use it as a barometer for risk in their investment portfolio. This can be a dangerous assumption for an investor, especially if their investments do not correlate to the S&P 500. While volatility is an important barometer of risk, it is not the only measure, and short-term volatility indices like the VIX only provide a narrow window into the overall risk picture of a portfolio.

Instead of solely looking at the VIX as a proxy for risk, we believe each asset in a portfolio should be evaluated. Proper portfolio construction can mitigate the effects of higher volatility and give a more accurate representation for the risk of a portfolio. Looking at the total portfolio risk can show how its assets are interacting with each other and are responding in various market environments.

More Risk Equals More Return

Typically, investors expect more return when they take on more risk. Everyone has heard that "in order to make more money, you have to take on more risk." But higher risk really means that you have the opportunity for higher returns AND for higher losses. Historically we've seen instances where more risk doesn't always equal more return. Over shorter-term periods, riskier assets can result in higher returns as compared to a lower risk portfolio, which can be misleading. These higher returns come at a cost. The severity of potential losses can more than offset the higher returns.

We believe investors should avoid the temptation to focus on a particular, concentrated asset that may have the potential for a high return. Instead, they should look at how a diverse group of assets can work together to meet investment objectives. A diversified portfolio with multiple asset classes (stocks, bonds, and real assets) can outperform a portfolio that is allocated 100% to equities over the long term with lower overall risk.

Risk comes in many forms and can be analyzed from various viewpoints. Risk is also much more than just simply looking at volatility. It takes true analysis and a deep understanding of potential investment risk to be able to provide investment solutions that perform how advisors and their clients expect them to. We take great pride in our quantitative assessment of risk and strive to put it at the forefront of our asset management decisions.