NOVARE®

UNIT TRUSTS 101

INVESTMENT RISK

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INVESTMENT RISK

WHAT IS RISK?

There is no one definition of risk and no one answer to the problem of managing risk. For some, "risk" is synonymous with the threat of loss. For these people an investment is risky if there is any chance of a decrease in the value of the starting capital. Some individuals think of "risk" as the prospect of total loss.

For others, risk is another word for unpredictability. This is closer to the formal definition of risk, where a risky investment is one with an uncertain (but not necessarily negative) outcome.

There are even people for whom the word risk evokes excitement and opportunity. Where risk is fear of loss the investment objective is often protection of capital, which, conventionally, usually means conservative low-return investments. But this approach carries another risk: inflation risk, the risk of losing value in real terms.

The unit trust industry is rightly concerned with measuring risk and finding ways to match investors with appropriate investments. This endeavour is complicated by shifting sands: the risks of different asset classes are not consistent over time and the circumstances of investors are changeable.

*Source: Profile's Unit Trusts & Collective Investments

RISK = REWARD

It is universally accepted principle of investment that risk rises with the potential for higher returns. Put more simply: the greater the chance you can make big money, the greater the chance you can lose your shirt.

Collective investment schemes are typically designed to reward with greater returns those investors who are prepared to take bigger risks. Long-term studies of the performance of different asset classes (like property, bonds, cash and equities) invariably show the superior performance of the equity market over the long-term. Over the vast majority of 10-year periods, historically, equities have on average outperformed property and bonds.

TYPES OF RISK

Investors who have a feel for different types of investment risk are in the best position to quantify risk, balance the risk, or decide whether the risk is worth taking.

MARKET OR BENCHMARK RISK

Benchmark risk is the risk inherent in a particular market, like the SA equity market, the US bond market, or the local property market.

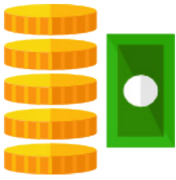
MARKET TIMING RISK

If you make a very long-term investment in a fund which is very well diversified across, say, South African equities, you eliminate some risks (like sector risks) and increase your exposure to benchmark risk (i.e. the risk of the SA equity market itself). It is a characteristic of nearly all markets that they rise and fall. The "wave" formations of different sectors go up and down at different times. Gold might be rising while financials fall, or bonds might be rising while the retail sector falls.

Some managers strive to add value to the performance of their funds by actively shifting market exposure to take account of market movements in different sectors. Multi-asset funds, especially Flexible and High Equity Funds, allow fund managers to take full advantage of market timing by shifting funds from asset allocation class to another according to which assets they think are going to perform.

Market timing risk is really the danger that someone trying to exploit market cycles and "hot" sectors will make matters worse by getting it wrong. Obviously, getting it right can lead to superior returns.

*Source: Profile's Unit Trusts & Collective Investments



CURRENCY RISK

This is the risk that otherwise good investment returns will be eroded by a weak currency.

GEOGRAPHIC RISK

Even if international exchange rates were fixed, there would still be the issue of different markets in different countries performing differently.

SECTOR RISK

Different sectors of the market will perform well under different circumstances and at different times.

FUND MANAGER RISK

The performance of any collective investment scheme is at least partly dependent on the decisions made by the portfolio manager. Diversification is, again, the easiest way to reduce fund manager risk.

ORGANISATIONAL AND ASSET RISK

One aspect of organisational risk is the danger of a fund manager going out of business or deliberately defrauding investors. While one shouldn't dismiss this entirely, the collective investments industry is well regulated and there is little change of investors losing money through fraud or insolvency if they are invested in FSB-registered funds.

Asset risk is the danger of insolvencies within a fund's portfolio. Another aspect of organisational risk relates to the impact of high-level policy decisions, mergers, changes of ownership or major staff movements.

LIQUIDITY RISK

Liquidity risk refers to both the liquidity of the cash component of the fund and the liquidity of the stock in the fund.

STOCK PICKING RISK

Having all your eggs in one basket is a great strategy – provided you pick the right basket. Stock picking requires in-depth knowledge of the market, the economy and particular companies. Stock picking risk can, of course, be reduced through diversification.

*Source: Profile's Unit Trusts & Collective Investments

The Financial Services Board (FSB) has officially taken up its new mandate as the Financial Sector Conduct Authority (FSCA), effective 1 April 2018. This marks the formal implementation of the Twin Peaks model of financial sector regulation, as envisaged in the Financial Sector Regulation Act 2017 (FSRA). The FSB will henceforth be known as the FSCA.