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Market Ethos

The latest market insights from Richardson Wealth

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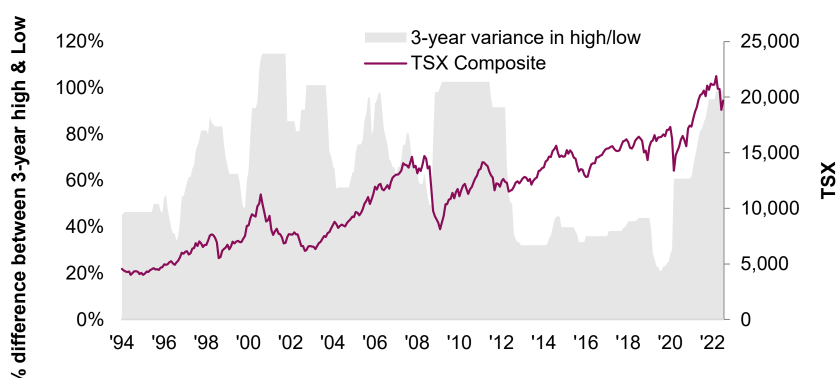
Let’s talk about risk

It’s been quite a ride. In the past three years, investors in the TSX have experienced a 37% drop over a one-month span, a subsequent 109% gain over two years, a 16% decline over three months and most recently a 10% gain in the past few weeks. These are big swings, some of them blindly fast. In 2022 add in inflation as a top issue, eroding how much we can buy, coupled with rising recession fears. To top it off, prices across asset classes and markets are moving more in tandem than usual, reducing diversification benefits. We cannot imagine a more fertile backdrop to think about risk.

Past few years has seen the TSX at 11k and 22k, raising the risk of behavioral mistakes



Source: Bloomberg, Purpose Investments

Don’t worry, we are not going down the math road of talking standard deviation, semi variance or various moments [although if you want to ring us, we *do* like talking math]. The math is all about trying to quantify volatility, but risk incorporates so much more than how much an investment may go up or down. In fact, risk is more so in the eye of the beholder – the investor.

Based on the core foundation that taking on higher risk increases the return expectation (clearly not with certainty), and that less risk has lower return expectations with greater price stability (again, not with certainty), all investors sit somewhere on this spectrum. The list of inputs is long and ranges from time horizon, wealth, cash flow, investment acumen. **But sometimes an investor’s capacity for risk is different than their tolerance.**

Capacity versus tolerance

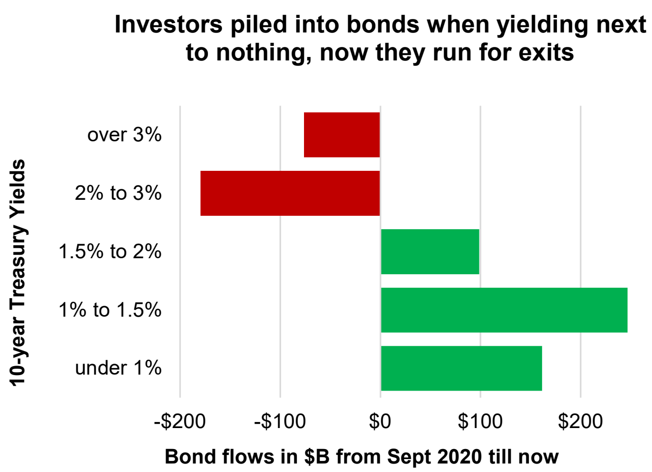
Capacity is a function of the size of an investor's portfolio, contributions, and the requirements from the portfolio. For instance, if a portfolio has a sizeable cushion (e.g. a large portfolio based on planned defunding requirements), the risk capacity is higher. Or if an investor still has many years of portfolio contributions ahead based on their savings and income, again, the risk capacity is high.

Conversely, investors who have retired and lack a decent safety cushion have less capacity to take on risk because adverse changes in the market to the portfolio's value could jeopardize the portfolio's objectives. Capacity has much more to do with financial planning and can be quantified with a good plan.

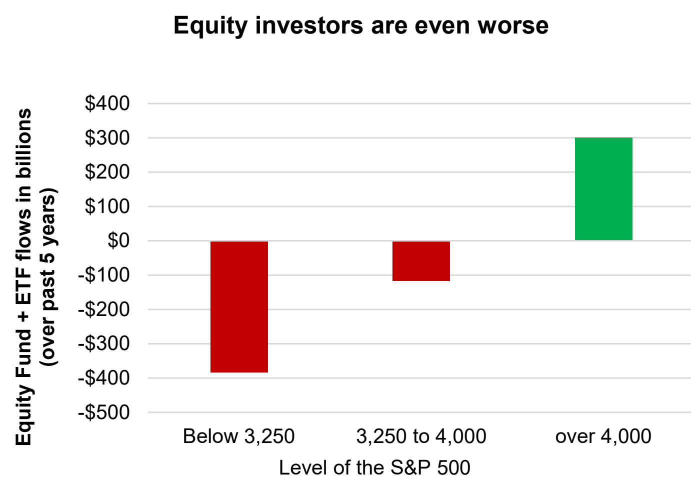
On the other hand, risk tolerance is a function of an investor's behaviour. Low tolerance for risk increases the risk of making a behavioural mistake, such as bailing from investments during downturns and causing damage to the long-term return potential of the portfolio. Usually for investors with lower risk tolerance, a less volatile portfolio is used. High-risk tolerance, especially when markets are moving higher, eliciting the fear of missing out, can lead to performance chasing. Ask an investor how they feel about risk after a 50% gain compared to a 50% loss and you may get a different answer. **Risk tolerance can change substantially with the markets,** so it's important to understand if you have a highly variable risk tolerance.

Perhaps the easiest way to see changing risk tolerance is to look at performance chasing. Investors had no problem piling into bonds when the prices were high and yields low. Bonds had performed well, and money poured in when yields were next to nothing. Conversely, equity investors felt more comfortable adding money to equities when the S&P was above 4,000 but took money out when much lower. **The more the price of something goes up, the higher people's risk tolerance becomes. Conversely, the lower the price, the higher the perceived risk.**

Fund & ETF flows - evidence investors more often buy high and sell low



Source: Bloomberg, ICI , Purposee Investments



Source: Bloomberg, ICI , Purpose Investments

Note – There are times when tolerance is different than capacity, which can be a dangerous combination. It can lead to taking on too much risk given capacity, often in rising markets, and result in a divergence from the longer-term financial plan. And since risk tolerance can change, often with the markets, a disconnect can arise quickly. Reverting to focus on the long-term plan can help reduce the risk.

2022 is a great year … to think about risk

Most portfolios are down so far this year. While it might not be a great year from a performance perspective, given the number of twists and turns, it is a good year to get to know your risk levels.

The first half bear – The TSX fell 18%, the S&P dropped 24%, and Canadian bonds were off by 14% by mid-June. Both bonds and equities are down, clearly not kind for most portfolios. And there were some harrowing single-day drops of 3-4%. So, how close during the first half of 2022 did you come to changing your asset mix? That real-life experience likely tells you much more about your risk tolerance than any questionnaire or hypothetical scenario. It also likely told you something about your risk of making a portfolio mistake.

- Those who bought or thought about buying to add market exposure clearly have a higher tolerance for risk and contrarian behaviour, which is a good investor characteristic.
- Those who thought about selling or sold to reduce market risk (this likely captures the majority, based on market fund/ETF flows at least) have a lower risk tolerance, or at least a risk tolerance that is more sensitive to market gyrations.

Bounce off the bottom – Markets have partially recovered over the past couple of months. Even many of the speculative investments that flew the highest in 2021 and fell the most in the first half of 2022 have risen the most during this 'bounce.'

- Has this bounce elicited strong feelings of missing out? This would certainly demonstrate a highly variable risk tolerance/appetite.

Please note we are not saying making tactical portfolio changes is wrong when markets are volatile. Far from it. But the changes should be supported by a well-researched perspective. Avoid making portfolio changes based on your personal changing tolerance or appetite for risk – these are most often the wrong decisions.

Inflation risk – This is a risk that remained dormant for decades and is certainly back. Looking past the current elevated headline numbers and the near-term path, the big risk is that inflation comes back down but settles at a higher level, say, 3-4% instead of 1-2%. What does that do to your financial plan or capacity for risk?

It may prove useful to update or scenario test a longer-term financial plan by inputting a higher inflation rate. And if that uncovers a great risk, save more or nudge the portfolio a bit more towards investments that can better handle inflation.

2022 – A year more prone to mistakes

With the big market moves, both up and down, 2022 is a year in which many investors are at higher risk of making a portfolio mistake. And it isn't over.

Here are a few guidelines to help you stay the course:

Create a plan – To understand your capacity for risk and to help tether your risk tolerance when it strays, a long-term plan really helps. It enables you to look past near-term gyrations and focus on the longer-term goal.

Get a second opinion – We are all emotional, and when the value of our money is changing quickly, emotions often run higher than normal. This is the time you are most at risk of making a mistake. Getting a second expert opinion really helps. Think of it like diversifying your emotions with others to help avoid an emotionally driven portfolio decision. During these times, the value of advice often shines brightest.

Take a break – Sleep on it. Often your subconscious will process more information and lead to a better decision.

Be wary of performance chasing – Most believe performance chasing happens only in up markets. Not true. The first half of 2022 has been unusual – similar to 1994. The risk now is that investors are lured into strategies that worked well in the first half but have not worked well in previous years. For instance, CTAs did very well in the first half, certainly worth considering but don't load up on what worked in this unique market environment. It may be a long wait for a repeat of the first half of 2022.

Understanding yourself and how you react (or want to react) to market moves up or down can help you become a better investor. Don't let emotions drive your investment decisions. The truth is great investors often don't have a crystal ball; they simply make fewer mistakes than others.

Source: Charts are sourced to Bloomberg L.P., Purpose Investments Inc., and Richardson Wealth unless otherwise noted.

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*This report is authored by Derek Benedet, CMT a Portfolio Manager at Purpose Investments Inc. Effective September 1, 2021, Derek Benedet has transitioned to Purpose Investments Inc.

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