Risk Diversification and Consumer Protection

1. Background

This Briefing Note should be read in conjunction with BN 21 and BN 22.

2. Risk

What is 'risk' in investment terms? Or rather what is risk as it applies to retail investors saving into mutual funds?

The dictionary definition of risk is 'hazard, chance of loss'. Now, in investment terms for mutual fund investors, the chance of absolute and total loss is very low. In fact, the only way such an investor can experience an actual 'loss' is if he cashes in the investment. He will then crystallise the reduced value of the investment and switch units to cash.

For retail investors using mutual funds, 'risk' is not the chance of loss but the volatility of returns. How much up and down movements your investments exhibit. There is also a direct correlation between volatility and returns. The more volatile the asset, the greater the opportunity. That is, the 'riskier' the asset, the greater the potential for gain or loss. This potential gain is your reward for taking a risk. Risk is therefore your friend.

3. Systemic and Specific Risk

Your assets will be subject to two main 'risks': -

(i) Systemic Risk - Is that attributable to the particular class to which the asset you own belongs. Therefore, a smaller company fund is more risky than a larger company fund. Smaller companies are by definition, more vulnerable to shocks in the financial system and business environment and will react more violently to threats and opportunities. There is nothing the companies can do about this and their share prices may suffer, or benefit.

(ii) Specific Risk - This is the risk that the fund manager will make bad decisions in running your money. His stock selections will prove poor and your fund will underperform.

4. Mitigating Systemic and Specific Risk

So is there any way we can manage these risks for you? Well, yes. With regard to systemic risk, the simple answer is to diversify. That is, do not have all your money in one type of asset. You can diversify across asset classes and within asset types. So, for example, within asset types you may hold both large and small company shares, as well as UK and overseas stocks. There will be some negative correlation that will reduce risk.

Diversifying across asset types is very effective. You would hold a mix of shares, bonds, property and cash. Bonds (or fixed interest securities) have a lower risk to capital than shares and generally negatively correlate with share prices. It is possible therefore to use bonds to control portfolio risk.

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With regards to specific risk, you can do something similar and that is to 'spread your bets' across a selection of managers, as a hedge against one of them making mistakes. You could also ensure that they manage money in different ways. Or you can choose to remove the specific risk altogether by not using actively managed funds.

5. Passive Fund Management

We break down passive funds into two categories: -

(i) Index trackers.
(ii) Passive funds.

The principle behind both types of fund is that as, on average, no active fund manager can ever consistently beat the returns of the market as a whole as measured by an 'index', why bother? This index return is in effect the average rate of return on capital that the average investor expects for his money. This is the market rate of return.

The other advantage is that usually passive funds have lower charges than actively managed funds. Passive funds use statistical techniques to identify which stocks to buy. Active funds are run by managers and their support staff who use talent and analytical techniques to choose stocks to buy. People are expensive and therefore actively managed funds have higher management charges. This piece is about risk, not cost and therefore we are not pursuing this part of the argument here.

In general then, it is possible to reduce specific (manager) risk by using passive investment techniques, which simply aim to capture market rates of return.

There are subtle differences between basic Index Tracking Funds and more sophisticated Passive Funds. Many commentators and industry people use the terms interchangeably, but we differentiate between Trackers and Passive Funds. Passive Funds seek to capture the rates of return of particular market segments and base their stock selections on Modern Portfolio Theory and the Fama/French Three Factor Model (see WFW BN??). However, this still means that the specific risk of active management has been removed.

Clients then often query why we only use one Fund Manager to run money in this way. Surely, this must lead to increased specific risk. Well, no. The Manager we currently use is just the one we judge to be the best at running the MPT/Fama/French Model at the most competitive price. All they have to do is set up the most efficient method of running the model. If someone else came along who could be identified as being able to run the model better and for the same or less money, then we would change. In other words, the manager should be of not interest to you. All you would want to know is that all money is being run correctly in accordance with the model.

We appreciate very deeply that risk and especially investment risk is an emotive subject for all clients. Our experience over many years and many clients also tell us, that understanding risk presents many people with a severe challenge, not the least because in many ways it is counter-initiative. Our business philosophy is therefore based on the principal of understanding. We will only pursue investment work with you if we are confident that you fully understand the nature of investment risk.

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