

# STRATEGIES FOR MANAGING RISK

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# DISCLAIMER

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- The material in this presentation is extremely general in nature and takes no account of the individual needs of any particular investor

# TODAY'S PRESENTATION

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- The need is to take a broad view of investment risk
- What are the big lessons on investing I've learnt (and sometimes re-learnt) from 54 years of experience?
- What's the mistake most often made by investors – and how does it contribute to investment risk?
- How can we best cope with the main forms of investment risk?

# TAKE A BROAD VIEW OF INVESTMENT RISK

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# THE RISKS OF INVESTING GO WELL BEYOND THE RISK-RETURN ANALYSIS

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- People looking at “risk” and “return” on investments often use historical volatility (= variance) to measure “risk”
- This assumes that history is a complete guide to what will happen in the future (alas, “black swan events” happen) ...
- ... and that future “risk” can be measured by the standard deviation of past returns
- Volatility (= variance) isn’t a good measure of risk



# THE RISKS OF INVESTING GO WELL BEYOND MEAN-VARIANCE ANALYSIS

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- To most investors, “risk” = the danger of “loss”
- Mean-variance gives investors some, but limited, understanding of risk
- Risk differs: across the main asset classes; within the main asset classes; and over time
- Be aware of your own tolerance for investment risk

# THE BIG LESSONS I'VE LEARNT FROM 54 YEARS OF INVESTING

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# 1.THE MAGIC OF COMPOUNDING

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- Make full use of the magic of compounding
- Examples: Westfield, Berkshire Hathaway, your house
- Be aware, too, of the shortcomings of compounding



## 2.THE NEED TO DISTINGUISH BETWEEN TRENDS, CYCLES AND WOBBLES

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- TRENDS are the average returns over the long term (for shares and housing = 10% pa nominal; 7% pa real; will these long-term returns continue)
- CYCLES are the big swings, up and down, around the trend rates of return
- WOBBLES are the sharp swings, soon reversed, such those of early 2016

# ON TRENDS, CYCLES AND WOBBLES

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- When there's a wobble, try to work out is it the precursor to a big swing in the cycle (eg 2008) – or likely soon to self-correct (eg 2011, 2016)

### 3.THERE WILL ALWAYS BE CYCLES IN THE ECONOMY AND INVESTMENT MARKETS

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- It's often said "the cycle is obsolete" or "the cycle has been tamed"
- But cycles continue because: we're much affected by the optimism or pessimism of others; governments do too much too late; credit moves in cycles
- No two cycles are ever the same

## 5.BE CAREFUL WITH DEBT

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- Debt increases potential returns and potential risk
- Heavy debts often bring grief to investors
- Australian households have a lot of debt. Need to think of “good” debt and “bad” debt.
- Worse time to take on debt is at top of the cycle
- Many investments are already “geared”



## 6.BE CAREFUL AND SELECTIVE IN CHOOSING INDIVIDUAL INVESTMENTS

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- For example, the criteria Investors Mutual Ltd and QVE use in selecting a portfolio shares are:
  - Competitive advantage of the company
  - Recurring predictable earnings of the company
  - Capable management of the company
  - The ability to grow the business over time
  - Attractive entry prices for the shares



## 7. RECOGNISE AND ALLOW FOR RISK

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- Recognise your tolerance for risk
- Expect occasional negative returns on “risk assets”
- Maintain a sensible diversification
- Don't over-borrow
- Allow for the many types of investment risk

# THE MANY TYPES OF INVESTMENT RISK

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# RISKS FROM THE CYCLE IN INVESTMENTS

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- The cycle lives on, in the economy and investments
- Investors need: to allow for good times and bad times; to watch out for turning points; to maintain sensible diversification; to think carefully about their asset allocation; to invest counter-cyclically

# TIME IN THE MARKET OR TIMING THE MARKET?

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- Some investment advisers stress the importance of time in the market – and almost give it shibboleth status
- Often, they draw on past decades of data on average returns and volatility to show prospective returns and risks - and encourage a “buy and hold” approach to investing
- Prepares investors for volatility in returns; cautions against dumping quality investments in extreme gloom ... but

# TIME IN THE MARKET OR TIMING THE MARKET

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- Often those who favour TIME IN THE MARKET over-state their case - by claiming anyone who misses out on the top dozen or so days over a decade or more would lose out badly
- There is also a case for investing when the dominant sentiment is gloomy, for taking some profits when markets are frenzied; and for dynamic asset allocation. That is, for TIMING THE MARKET
- In a sentence, there is room for both timing the market AND time in the market



# MANAGING THE RISKS FROM INFLATION

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- Inflation complicates investment decisions via its effects on: interest rates (nominal and real); the purchasing power of principal sums; the multiples on earnings; time horizons; policy reactions; etc
- The effects of inflation usually turn out to be non-linear: shares protect against low to moderate inflation but not high inflation
- Currently, investment markets are expecting negligible inflation for a decade or more. In truth, an inflationary cycle is likely
- Note - availability now of inflation-linked bonds

# MANAGING THE RISK FROM DEBT

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- As mentioned, debt increase returns and risk
- Note: for borrowers, variable rate debt can be good (2015, 2016) or bad (1988, 1989)
- Important for investors to be aware: how debt can hurt; how much debt they have; and to think about the difference between “good debt” and “bad debt”

# WHAT MISTAKE DO INVESTORS MAKE MOST FREQUENTLY?

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# THE MOST FREQUENTLY-MADE INVESTMENT MISTAKE

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- Too often, investors take a recent experience and extrapolate it ahead as a lasting trend
- Thus, a boom is expected to run “forever”
- And a slump is expected to run “forever”
- Investors who act this way tend to buy at the top of the cycle and to sell at the bottom of the cycle



# POINTERS TO IMMINENT RECESSION?

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- As an example, a collapse in share prices is not a reliable indicator of early recession. Paul Samuelson in 1966: "The US share market has predicted nine of last five recessions"
- More reliable indicators of an imminent recession are: the yield curve becoming steeply inverted; a big build up in inventories; the severe drying up of credit; a sudden loss of jobs; a sharp decline in profits



# TO CONCLUDE

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- Be aware of and understand your tolerance for risk
- Take a wide approach to investment risk
- Sensible diversification, sensible selection of assets
- Don't simply extrapolate ahead the recent experience in investment markets

# WISE WORDS FROM JOHN TEMPLETON

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- Bull markets are born on pessimism, grow on scepticism, mature on optimism and die on euphoria
- “This time is different” are the most costly four words in market history