Managing risk

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INVESTORS

Risk reflects uncertainty

Risk reflects uncertainty but, for an investor, risk is generally a desire to avoid a permanent loss of capital.

The trend over the last few decades has been to rely on increasingly sophisticated models in an attempt to manage risk. Modelling has a role but we believe far too much emphasis is placed on trying to predict the future using information from the past. This leads to false confidence and misguided portfolio construction.

We do not think the future can be predicted in a consistently successful manner, as financial markets are highly complex, often unstable systems that reflect human biases. Instead, we recognise the future arises from the present and from the real

world. For example, risk comes from areas such as economic growth/recession, deflation/inflation, investor behaviour and the credibility of policy makers. We look to understand these aspects to better appreciate the risk environment.

Risk is not always bad

We have to take some risk in order to achieve our investors' desired return outcome. Investors ultimately know that future returns are uncertain but, understandably, wish to have some greater confidence that their funds are being run in ways to confine risk within certain bounds.

Our job is to have the best understanding we can of the sources of risk we are taking and diversify that risk both by asset class and by real world scenario, in order to achieve as smooth a journey as we can for our investors, while aiming to earn attractive returns.

There are certain risks that we are reluctant to take, such as political risk. Politics, by its nature, is generally opaque. We are not political scientists but from experience we do know that political risk, in the first instance, is often expressed through currencies, themselves very speculative in nature. The combination of political and currency risk is something we are happy to avoid, as we did in the EU referendum, which was a binary single day risk event, when our funds were outcome-neutral.

Economic risk contrasts sharply with political risk. The economic environment is defined by numerous and frequent data releases and so allows a picture to build over time. For example, in order to understand the health of the consumer, we can look at retail spending, consumer confidence, savings ratios, real income growth, employment prospects, the housing market and the stockmarket. With many more pieces of the jigsaw on the table, we are more comfortable building this type of exposure.

Risk is never static
(despite what the textbooks say)

Conventional wisdom suggests government bonds are low risk and equities are high risk. It also suggests that gold is a safe haven.

However, US government bonds are not always low risk and the degree to which they are more or less risky than, for example, US equities, changes over time. Gold, for example, has been a great diversifier to equities in the past but there have been extended periods when it has moved in line with equities.

In short, making assumptions is dangerous, just as relying on models is. We believe it is much more insightful to look in the here and now at how asset class behaviour is changing, relative to their history and relative to other asset classes. This helps build a picture as to the wider risk environment.

We are particularly obsessed with liquidity as corrective action is an important risk management tool, particularly in fast changing markets.

There's no risk in what we do not own.

Managing multi asset funds that have capital preservation at the core of their philosophy, rather than a benchmark, we have the luxury of choosing the risks we take. In short, we cannot lose money in what we do not own.

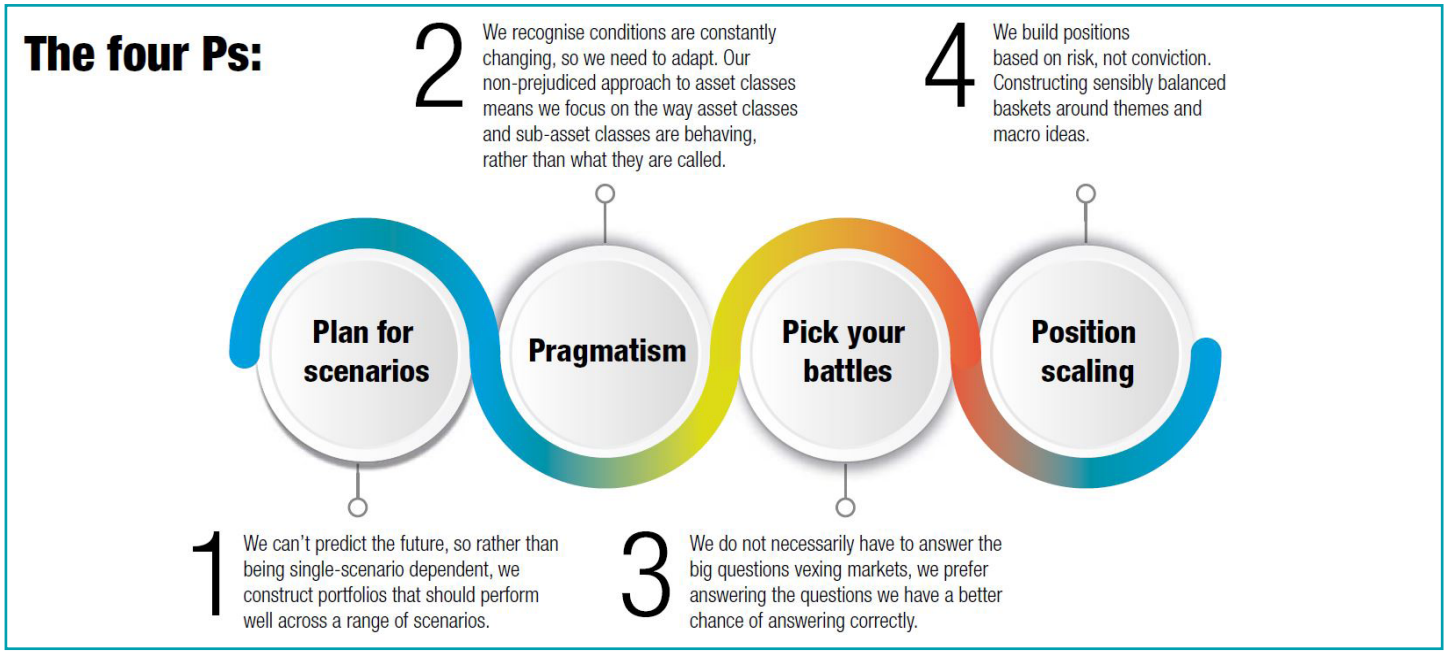
We compare it to an exam paper where you do not have to answer all the questions, just the ones that you have a greater certainty of getting right. For example, the direction of UK house prices seems more difficult to predict than whether the number of Indian consumers is going to grow over time. In this case, we do not have to invest in UK housing and, instead, it might make more sense to build exposure to the growing Indian consumer.

Be careful of "diworsification"

Conventional wisdom suggests a static broad-based exposure will achieve diversification, although we think this falls into the trap of "diworsification".

As we've mentioned, risk is not static and so we think that a pragmatic and "live" approach to diversifying risk is much more appropriate. Ideally, we can find assets whose sources of risk and return are relatively unrelated to the other assets in our funds but the true test is whether funds withstand risk shocks.

Ideally, every position in the portfolio contributes to being shock-resistant as well as being an additional positive in the portfolio, for example being part of a portfolio theme.



Conclusion: The proof that we take an appropriate approach to risk is not in some single risk measure, but in the experience of our investors during difficult times, as well as in rising markets.

We are outcome investors. We manage multi asset funds with specific return and risk profiles over time. In short, they are designed to limit losses in difficult times but earn a satisfactory return over the medium term.

Miton Multi Asset team.

Risks

The value of stockmarket investments will fluctuate, which will cause fund prices to fall as well as rise and investors may not get back the original amount invested.