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The Reality of Investment Risk

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When you invest, you make choices about what to do with your financial assets. Risk is any uncertainty with respect to your investments that has the potential to negatively affect your financial welfare. Here is a reality check: all investments carry some degree of risk. Even certificates of deposit issued by the banks come with inflation risk. Currently, they definitely do, with the inflation rate probably outpacing any interest you might receive from the issuers. Furthermore, you still have to pay taxes on the interest income.

Defining risk in investment is a complex issue. There are many types of risks and here are a few:

- Your investment value might rise or fall because of market conditions (market risk);
- Corporate decisions, like acquisition of a new business division or merger with another company, can affect the value of your investments (business risk);
- Events in foreign countries in which corporations do business can affect the value of your investments (political risk and currency risk).

There are also a whole set of risks related to investors' behaviour: the risk of missing out, the risk of buying too early, the risk of selling too late and many more.

There is one concept of risk that we would like to address because we believe that its flaws can be turned into an advantage for the informed investor: the concept of volatility as a risk.

Risk, being the most interesting, challenging and important aspect of investing, has attracted many researchers in the academic field. Essentially, it comes down to one simple question: would it not be nice if risk could be expressed in a mathematical formula that could be taught in class so everyone could quantify and manage it?

Modern finance went to work 50-odd years ago, and with the help of complex mathematics, defined risk as price fluctuations or volatility. From then on, we have been able to apply our knowledge of statistics to measure risk. There you have it. If life were so simple, every mathematician would be rich…

Unfortunately, many questions arise from this concept of risk. A few come to mind:

· Since superior returns come from one's ability to invest when assets are cheap, how can we achieve outperformance without fluctuation, especially on the downside?

· Fluctuations are different depending on how frequent we want to measure them: daily, weekly, monthly or even annually. Does it mean that the frequency of measurement can change the level of risk of an investment?

· Certain asset classes don't get priced as frequently as stocks, bonds and cash, such as real estate, paintings, collectors' items and others. Does this mean no fluctuation thus no risk?

· Furthermore, they cannot easily be disposed of if there is an urgent need to do so. This is called liquidity risk and it is extremely difficult to quantify. Does this mean that less volatility due to liquidity issues means less risk?

Here is our more pragmatic perspective:

- Volatility is an informed investor's best friend: declining assets prices present the opportunity to buy the good ones cheaply and achieve above average long-term performance.

- Investors should view volatility like periods of turbulence in air travel: mostly benign if you can take the emotional "shake, rattle and roll." Like turbulence, volatility in itself is not a threat to a successful outcome in investments. However, it does tend to trigger inopportune reactions on the part of the average investor and gets them to sell and buy too often and continuously swap money in and out of their portfolio. In the long term, it will negatively impact the overall performance of a well-built investment portfolio.

- Investing is a long-term journey. It should be approached with patience, discipline, and diversification. The better informed the decision maker and the more thoughtful the investment process, the better the outcome. As Warren Buffett says it so well: "If you aren't thinking about owning a stock for 10 years, don't even think about owning it for 10 minutes."

In short, you cannot eliminate investment risk. But 3 basic investment strategies can help manage it:

Asset allocation: we always emphasize a combination of stocks, bonds and cash that reflect clients' financial needs. For those of you who live off your portfolio, it is of utmost importance that you have a plan of withdrawals that is consistent with the size of your portfolio and your goals;

For more information on asset allocation, click here.

Diversification: as you can see in your portfolio, we own a fairly high number of companies in equity and in bonds.

For more information on diversification, click here.

Rebalancing: we make sure to strike a balance between and within asset classes. We also use the cash portion of the portfolios to mitigate our exposure of different asset classes in case of price dislocation. As Howard Marks says, "You can't predict. You can prepare."

FAQs

We have been asked many questions regarding market timing, cryptocurrencies, inflation, interest rates, etc. As you know, we really don't like to predict because we are not very good at it. Furthermore, we do believe that if we were to go into the prediction business, we have to predict very often…and not get any better at it.

It does not mean we are not aware of what is going on. With that said, here is our perspective on different topics:

Timing the markets: we know for a fact that trying to get in and out of markets on a timely basis is a wishful thinking endeavour and more likely than not, will inflict great damage on your portfolio over the long term. Furthermore, **"time in the markets"** is what is essential. It is much easier for investors to learn how to deal with the roller coaster aspect of markets than try to figure out when to get on and off the roller coaster without accident…I would refer you to the first part of the letter with regards to how to deal with volatility.

Cryptocurrencies: we really feel we are out of our circle of competence here. We have a tough time reconciling the concept of investment in cryptocurrencies with the definition of investment itself: an investment is an asset that produces or is expected to produce an income in the future so an investor can put a valuation on it; otherwise, it is a speculation, an activity where people bet on the future change in prices. Not that there is anything wrong with speculation. Even Benjamin Graham makes a distinction between speculation and intelligent speculation. But it is not an investment.

However, we do believe there will be forms of digital currency in the future. In fact, credit cards are already a form of digital currency. We also believe that money transfer technology is antiquated today because the banks have no incentives to change. It is after all a big profit centre for the financial institutions. Hopefully, fintech companies will help to change that. As for potential investment in this field, we would rather follow Warren Buffett's advice regarding space travel: "As investors, our reaction to a fermenting industry is much like our attitude toward space exploration: we applaud the endeavour but prefer to skip the ride."

Inflation: the most obvious and basic economic factor that affects markets is Supply and Demand and it has never been more evident than during the pandemic. When governments around the world distribute money to everybody to avoid economic collapse due to shutdowns, they basically stimulate the demand side of the economy by encouraging people to continue spending. At the same time, in order to avoid COVID contagion, they ordered the shutdown of the producing side of the economy, from transportation companies to manufacturing ones (supply side). As fewer products are produced and delivered, while demand continues to grow (no shortage of money), it would seem that near-term inflation is unavoidable. While some price increases are transitory, others will likely stick as demand continues and supply can only come back slowly.

Interest rates: theoretically, they should rise with inflation expectations although we have no idea regarding either the timing or the size of the increase. We do know that interest rates will affect asset price valuations and we will act accordingly. One thing is for sure: with interest rates being between 0 and 1%, the risk/reward of being wrong (interest rates go down instead of up) would be negligible (if you buy a 5-year bond at 1% and rates go down, you would still only earn 1% at maturity, not more. But if rates go up, you would be stuck at 1%...).

These are a few of the questions that come up often in our conversations with clients and we hope we have managed to give you a sense of what we think.

We also hope you have all enjoyed the wonderful extended summer and had a great thanksgiving period with your families.

We would once again like to say that the single most important measure of our success at Claret is our relationship of trust and partnership with our clients – for that, we thank you all.

Alain Chung, Chief Investment Officer for the Claret Team

Alain began his professional career in 1983 and is a CFA charterholder. He holds a bachelor's degree in Business Administration from HEC Montreal, where he graduated with honors. Alain co-founded Claret Asset Management and is the Chairman and Chief Investment Officer Before joining Claret, Alain worked for 16 years as an investment advisor and as a Vice-President at CIBC Wood Gundy. Alain speaks English, French, Cantonese, Mandarin and Vietnamese.