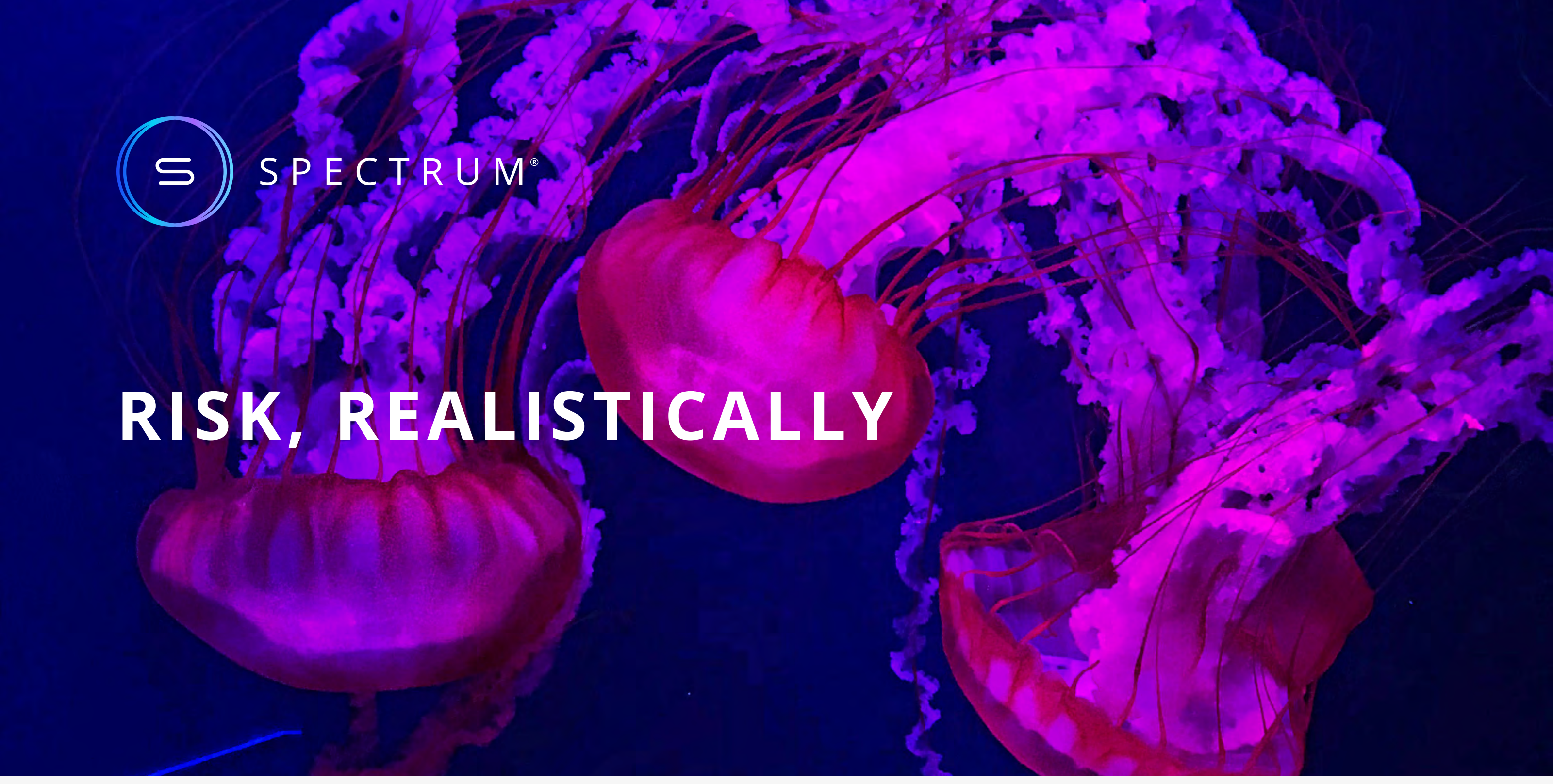

RISK, REALISTICALLY

Understanding the risks that come with investing is obviously crucial. The various perils might be confusing at first, but investors still need to make sure that their portfolio is in line with their risk profile. However, some risk measures miss the point as they don't address the real risk: losing money.

Mutual funds and ETFs are among the most popular tools for investors. While mutual funds usually seek to outperform a corresponding index or benchmark portfolio, ETFs aim to reproduce an index or benchmark portfolio as closely as possible. One measurement used to determine the risk of these investment vehicles is the tracking error – the higher the tracking error the more the portfolio deviates from the index. In other words, the closer a portfolio reproduces the holdings of its index, the less risky the portfolio is.

Like other risk measures such as the beta coefficient (measure of the volatility of a portfolio or a security) or the Sharpe ratio (calculation of the risk-adjusted return), the tracking error's significance can be questioned, though. Firstly, it is retrospective. It provides information on whether an investment approach has worked as effectively as intended in the past. While this evaluation could indeed be an indication of how well a portfolio manager controls the benchmark risk in the future, it doesn't really identify or control the future risk potential. For example, unpredictable events such as changes in the economic environment, in regulation or in portfolio management and how a fund's performance will eventually be impacted are naturally not 'covered'.

The second problem is that all of the measures mentioned above are relative. They only measure how a fund's returns differ from its benchmark. They don't measure the risk of losing money – even though, independent of an investor's risk appetite and investment objectives, capital preservation should always be a first-order condition. Also, the measures don't necessarily put the emphasis on the growth of the investor's initial investment.

During bull market conditions most investors in mutual funds or ETFs may not pay a lot of attention to the tracking error or other risk measures. As in such periods the markets go up in general, their investment will usually go up, too – albeit sometimes with only mediocre returns. However, during bear markets many investors see their originally invested sum or any gains melting away – maybe a bit less than the corresponding index, maybe a bit more. In any case, it is a painful experience! And although the risk measures might be in line with an investor's preferences, a good tracking error, beta coefficient or Sharpe ratio are poor consolation.

Against this backdrop, it seems much more prudent to monitor more tangible risks, those that are linked to the relevant asset class or a specific security in a straightforward manner, such as credit risk, for example. The entire risk exposure, the probability of default (PD) or the recovery potential in the event of a default (loss given default, LGD), may not bother you so much unless you're invested in bonds, bond funds or other instruments or asset classes bearing a counterparty risk. The credit risk in (equity-) ETFs from securities lending can be considered neutral. Talking of ETFs or equity instruments in general, investors face liquidity risk as it may turn out to be difficult to sell a position or several positions quickly. This type of risk will almost always take its toll since the cost of balancing illiquidity must be looked at as risk, too.

Recently, however, in their relative importance over the above discussed risk types, market risk and systemic risk have gained the upper hand: time-honoured safe-haven investments have not just lost their protection status, they underperform, too. And even if the worst irrational swings seem to lie behind us, volatility is still apparent and is likely to remain so.

Investors who are aware of the 'real' risks and prepared to do their research may therefore want to consider using the market's ups and downs to their advantage by pro-actively buying and selling (instead of accepting losses that may come with volatility). In fact, using the ongoing volatility is what many clients of Spectrum's trading service are already doing. The venue's range of highly liquid indices, currency pairs and commodities can be traded 24 hours, 5 days a week. This constitutes a more accessible and cost-efficient way to trade securitised derivatives and includes the opportunity to shorten assets through derivatives where they're deemed overvalued.

These extra attractive features have been in high demand since the launch of Spectrum Markets in 2019. The continuously increasing trading volumes are testament to the investor's appetite for innovative trading opportunities. Get in touch today to learn more about Spectrum as a true marketplace, allowing your clients to see orderbook prices and volumes, which enables more informed decisions during varying market conditions.

Please don't hesitate to get in touch if you wish to receive further detail.

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