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What is happening to risk?

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A view often heard in 2019, particularly when talking about share markets, was that “risk is high” or “risk is increasing”. Such a view was probably formed based on a combination of factors, including:

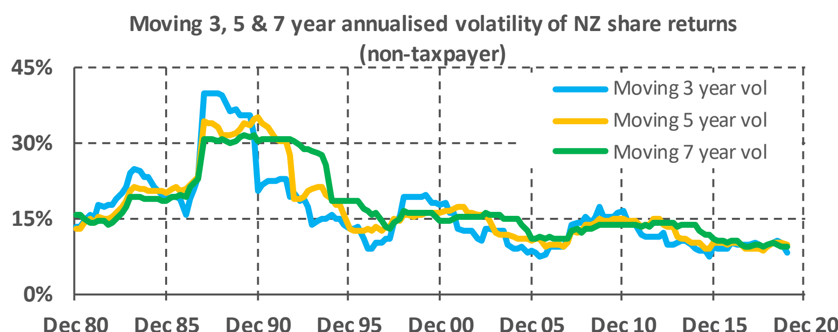
- Share markets had risen significantly and values seemed to be ‘high’, relative to history, based on measures such as PE ratios (price earnings) and revenue growth per share.
- There were a range of conflicts with citizens protesting in countries including Chile, France, Hong Kong and Venezuela.
- There were increased armed conflicts in Africa, Asia, Eastern Europe and the Middle East.
- Brexit, at least until December, was an unknown and UK politics was in turmoil.
- 3 years on, those that did not vote for Trump were still complaining about his unsuitability. The US, like many countries, seems more divided.
- Debt levels were rising, and economic growth was falling.
- Interest rates were at an all time low and investors were chasing shares and dividends, pushing share prices higher and ignoring equity risk.

It is important to manage the consequences of what might happen.

The important question is “if XYZ happened, will I still be able to achieve the goals?”

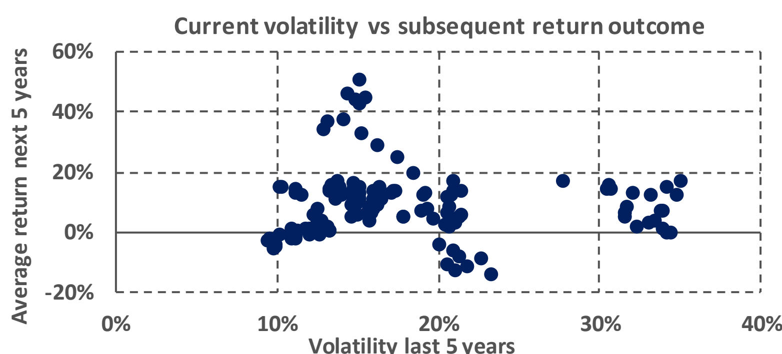
2019 was a year where there were plenty to worry about, if that was the objective. But was risk increasing?

Volatility



One of the common statistics used to measure risk, is volatility. The argument is that higher risk, or heightened uncertainty, causes increased fluctuations in the market and this shows up in observed volatility. Central to the argument is that there is a correlation between volatility and risk. But volatility, measured over the different 3, 5 and 7-year periods in the last 40 years for New Zealand shares is trending down. It paints a picture of falling volatility since the 80s, though there was a brief spike around the time of the 1987 share market crash.

If volatility was a good indication of risk and return, there would be a relationship (an upward sloping line) between different levels of volatility and returns.



Over the last 40 years, the 5-year annualised volatility plotted against the average return over the subsequent 5 years does not form a consistent pattern. The pattern is random, though it could be argued that a slight downward sloping line is the best statistical fit.

Actual volatility suggests that risk is falling. But volatility is not risk. At most it is a measure of past variability based on what

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happened and not on what could have happened (ie risks that were present). Past variability, like past returns, has proven to be a poor indicator of future returns.

Risks are conceptual

When it is said that there are risks and these may lead to poor outcomes, it is not saying that the risks will be observed and when they do occur, poor outcomes will follow. Risks are conceptual.

Each time you walk across a road you take risk exposing yourself to a potential poor outcome (death, injury or a near miss). You mitigate this risk by a combination of crossing at lights, using a zebra crossing, looking both ways before stepping out and allowing for the possibility that vehicle drivers may not comply with the law. The fact that we do not get hit, the most common outcome, is not evidence that the risk was not present. The same applies to investment markets; most potential risks do not occur in a particular period, but investors should always be in a position to manage the consequences, should they occur, so they still achieve their goals.

The risks associated with share markets (and the property, bond and cash markets) relate to the reasons why the prices of shares fall, or companies cut their dividends, or the shares become illiquid. Some reasons will fall into the economic or financial category (arising from high debt levels, low economic growth, low interest rates etc), some political (eg legislative change, political unrest, armed conflicts etc) and some will fall into the human emotional category. The key question is “will the event cause more investors to want to sell and therefore be the catalyst for a significant market decline?”

Risks reflect people’s actions

As a rule, markets go down when more people want to sell than buy and people may sell because they think the economic outlook is weak or declining, or because they are uneasy about a global event(s) or because they need the capital. Risk relates not to volatility but to the potential for an event to occur that leads to a high number of people wanting to sell leading to an adverse investment outcome. Notwithstanding that, the event may not happen.

Risk consequences should be managed

If something happens and the markets were to fall, does the investor need to sell before they recover? If the investor needs to sell, they will realise less than otherwise expected. This creates a poor outcome arising from a risk event that happened. If the investor does not need to sell, the risk still exists but there are no permanent negative consequences of the risk to the investor, as long as the investor does not panic and sell anyway.

What is important is how investors will manage the potential consequences of things that may happen (risks) where they would have a negative impact on them, to reduce the adverse outcome. In some cases, this might be to avoid an investment (eg sell an asset or not buy it in the first place). In other cases, it will be to make sure that the goals can still be achieved while the temporary but negative consequences (eg a fall in value) dissipate.

What is important is how the consequences of what could happen are managed. The important question is “if XYZ happened, will I still be able to achieve my goals?” The list of potential events that might happen that could lead to the share and/or bond markets declining, appears to be elevated. The does not mean that they will happen and probably most will not – the consequences just need to be managed and there needs to be a plan.

Also, no one knows whether volatility will continue to decline, but volatility is not risk.