

Preparing Clients for the Ugly Times: Risk and Return

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We might wish our clients' investment journeys will invariably be beautiful experiences but we know that things will turn ugly from time to time. How do we prepare our clients for the ugly times? What do they need to know?

It seems to me that what we need to do is give them a feel for the likely pattern of the experience that lies ahead. We can do this through stochastic modelling but the technicalities are likely to be overwhelming and the results' lack of concreteness mitigates against the learning experience.

Accordingly, our explanation of risk and return should include lessons from history. We can look at what would have happened in markets past with the portfolio we are now recommending.

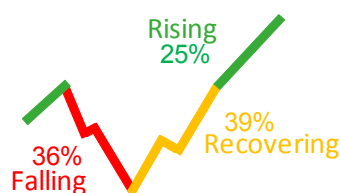
Perhaps the place to start is with how often the value of the portfolio would have been falling, recovering and rising: falling from a previous high, recovering from a previous low, rising from a previous high.

For example, let's look at the monthly historical performance over the past 40 years of a 70% shares portfolio, where each of the months is categorized as falling, recovering or rising (*see note below for more details on the portfolio's composition*).

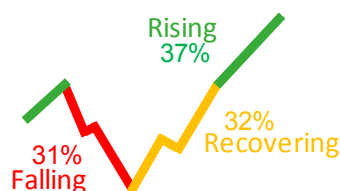
What we see is that the portfolio was falling 36% of the time, recovering 39% of the time (recoveries tend to take longer than falls) and rising 25% of the time. So our client should be aware that when they look at the value of their portfolio, it is likely to be falling a quarter of the time.

But what if our client has a more conservative portfolio, say, a 30% shares portfolio? Perhaps somewhat surprisingly, the pattern is very similar: roughly $\frac{1}{3}, \frac{1}{3}, \frac{1}{3}$.

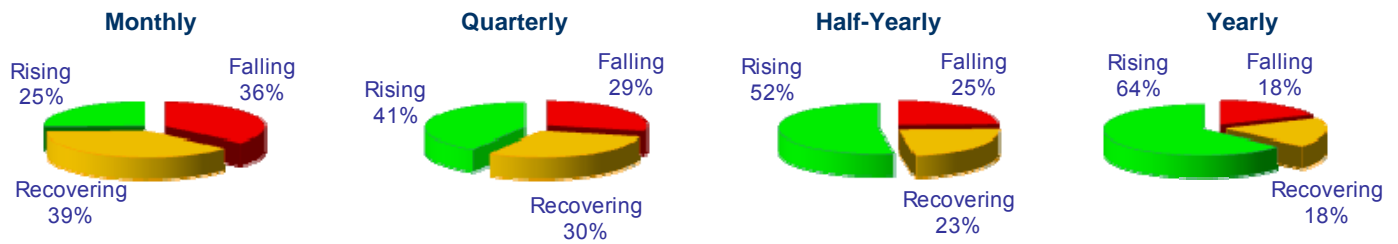
70% shares and Property



30% Shares and property

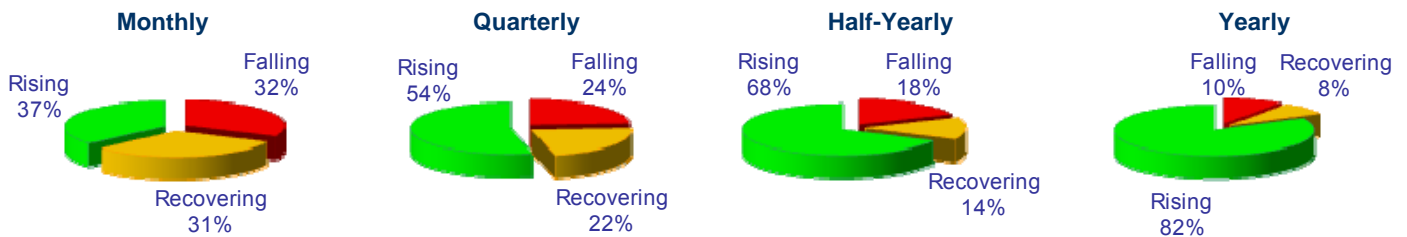


So far we have been looking at monthly data, i.e. what a client will see if they look at the value of their portfolio every month. However, if the client looks less frequently, the pattern changes dramatically. With our 70% shares portfolio, the pattern is:



As we move from monthly to yearly the frequency of rising more than doubles and the frequency of falling halves. From a behavioral finance point of view, given the overweighting of losses versus gains, the yearly picture is roughly four times more beautiful than the monthly picture.

The difference is even more dramatic with the 30% shares portfolio.



At monthly, the portfolio is marginally more likely to be rising than falling whereas at yearly it is eight times more likely to be rising than falling—a much more beautiful picture indeed.

Clearly, the less often we look the happier we will be. Of course, being human, when markets wobble the urge to look can be irresistible, but we can warn clients that the more often they look the less beauty they will see...and remind them of this warning in volatile times.

Portfolio Composition Note:

The data being presented here is from FinaMetrica's historical portfolio performance analysis.

The 70% shares portfolio is 10% UK fixed interest, 20% international fixed interest, 40% UK shares and 30% international shares, and the 30% shares portfolio is 40% UK fixed interest, 30% international fixed interest, 20% UK shares and 10% international shares.

Total return indices are used as proxies for sector performance and the portfolios are rebalanced annually. The period covered is 1st January 1970 to 30 June 2011. More detail of this analysis can be found in the Risk and Return guides under Resources at www.riskprofiling.com