How to understand the risk in your investments

How do you ascertain what your attitude to risk is when you are investing money, so you aren’t surprised when markets take a downturn? If you have a pension or investments, strap yourself in, and read on.

Firstly, returns and risk go hand in hand. If you sit in your garden, the view is consistent, jump off a Swiss Alp and the greenery is quite different, as is the risk.

We take risk in order to beat inflation and keep our buying power ahead of it, otherwise we lose our power to buy the same goods. The greater the risk, the greater the potential for a return over inflation, and the greater the potential for loss. They go hand in hand.

There are many methods of calculating risk and these should be left to the specialists. For example, here is one that can go wrong through oversimplification. A method used to ascertain the risk of an investment is standard deviation. What’s that?

In simple terms, you calculate the average return of a fund and then calculate how much it deviates away from that return each month. It’s a simple method of calculating how much deviation is occurring to achieve a return.

So, a fund produces 6% in a year, but is up and down 3% every month, isn’t better than a fund that produces 0.5% each month on month, and finished up 6%.

Standard deviation has many flaws, the least of which was shown with the horrific collapse of fancy investment strategies in zero dividend preference shares. These had a standard deviation of almost zero, a cardboard licking volatility that meant you just couldn’t go wrong. Until they did. Standard deviation measures just one element of risk, which is like choosing a political leader because of their smile.

A £100,000 investment in these lovely cute zero dividend gremlins was returning pence the following day, because at the core was a completely misunderstood risk which set them to the back of the queue if an investment went belly up. And they did, causing financial hardship for many, and throwing financial firms to the wall.

Furthermore, assessing standard deviation over a three-year period is like licking a restaurant window to test the menu. It is, however, very, very common indeed. If a fund is rising during a momentum market (often happens), it can do so without varying much in its upward cycle. Over a five-year period however, there is likely to be more chance of a downturn and that is where the Swiss Alp risk is more likely to be shown for what it is.

One fund I looked at had a reasonably low standard deviation and could have looked grand with its performance that was attributed to it, but three further assessments showed it to be far from a bonny bag of nuts.

I calculated the downside risk, maximum drawdown and maximum loss of every fund in its sector to ascertain key risks that standard deviation wouldn’t necessarily highlight: when this fund falls, how far does it fall from its peak; for how long does it fall without rising; and finally, an assessment/estimate of the potential loss of an investment.

When I calculate these measures and compare each fund in the sector against each other the numbers are illuminating. Many would simply be buying a fund based on a basic mathematical error.

This is also highlighted with another assessment called Sharpe ratio. This analysis is supposed to capture the potential for excess return relative to the risk of the investment but doesn't always do that, as it doesn't always capture the inherent risk.

One of the greatest risks to putting your money in the wrong place for the best returns (and not getting them), however, is your understanding of risk.

If you are asked "What is your attitude to risk, 1-5" as a measure, the response is likely to be equally as daft.

Understanding the basics of an efficient frontier curve (rather than its in-depth mathematical analysis) is a great starting point. In short, for the risk I am taking, is this reward correct? Or, for the reward I would like, am I taking the minimum (or at least correct) risk? More on how to minimise risk next week.

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