

Does 'low risk' really mean low risk?

By Quintin Rayer | May 17, 2018

Previously Quintin Rayer looked at risk in financial products; with emphasis on the different forms risk may take [1]. Here, a useful way of looking at risk between different financial products is considered, with an overview of some key risk components and a liquidity risk example.

Introduction

Advisers play a crucial role in communicating product risks to their clients. However, many apparently lower risk products (with perhaps low volatility), may bear higher risks elsewhere. Of course, risk can appear in many different forms [2]. Often, rather than being eliminated, risks change and reappear somewhere else. This can occur in unobvious ways, and it can seem as if some 'risk alchemy' has taken place [1], [3].

As a rule of thumb, one might expect that for a given level of expected return, risk levels between different products should be similar. If risk appears different, it is likely that it has changed form. This appeals to a generalised risk-return trade-off, with riskier assets commonly accepted to have a higher level of return, a sort of idealised Capital Market Line or risk premium expectation [4], [5].

Visually one may think of total risk as being like a balloon – with areas on its surface marked 'volatility'; 'credit risk', etc. If the risk balloon (for a given level of return) is squeezed to diminish volatility, it suggests the balloon must bulge out somewhere else, perhaps at 'credit risk', or 'counterparty risk'.

So products that are expected to deliver similar returns but having differing apparent risk levels should be examined with the above rule of thumb in mind. If products have similar expected returns, perhaps one should assume the risks must be similar, but taking different forms. An adviser can then ask 'where has the risk been moved to?' to gain additional perspective.

Understanding the many different forms risk can take is beneficial for portfolio managers, but it is also vital that advisers effectively communicate product risks to clients. Hence as to how portfolios might respond to specific market outcomes or other concerns.

Components of risk

Does 'risk' mean volatility, credit risk, default risk, liquidity risk or what? It should include all of these and more; volatility is hardly a complete measure of risk alone.

There are different ways of breaking down risk into its components [4], [2], an illustration is shown below.

Total Risk	=	Market risk (volatility)	+	Credit risk	+	Counterparty risk	+	Liquidity risk	+	Term risk	+	Other risks
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Apart from volatility and credit risk, it includes counterparty risk (another party being unable to meet their obligations); liquidity risk (when one wishes to sell an asset, one cannot, or no buyers can be found at a reasonable price); and term risk of being locked into a position for an extended period and unable to exit should this become necessary. Some risks would only occur under somewhat extreme conditions, but this does not mean they do not exist. 'Other risks' is a catch-all, including, for example, currency risk, operational risks and others not included.

Several of these are interrelated, for example, credit risk and counterparty risk both require a counterparty to fail to meet obligations, although with different connotations. Liquidity risk and term risk are also related since one could be locked into a product for an extended period.

Some of these risks can be readily measured while others are trickier. Harder to measure risks can easily become neglected, until such times as they are uncomfortably proved to matter.

Liquidity Risk Example

Consider comparing a fictitious direct commercial property open-ended fund (whereby the fund itself owns physical buildings), with a fictitious multi-asset fund invested in equities and bonds. For the illustration, these are assumed to have similar expected returns.

The multi-asset fund exhibits volatility (price fluctuations), with bond credit risk and so forth. The direct commercial property fund may have low volatility, suggesting lower risk. But is this true? The property fund would hold some liquid assets to meet investor redemption requests, but otherwise

owns buildings. Its primary assets tend to get revalued either by a surveyor reappraising them or else when sold, resulting in slow price changes.

If many investors wished to exit, once the liquid assets are exhausted, the manager must sell buildings to raise cash – a slow and uncertain process. If the manager becomes a forced seller, he is unlikely to realise a good price for the buildings sold. The fund may have low volatility but clearly carries liquidity risk. Squeezing the risk balloon may have reduced volatility, but it has bulged out at liquidity.

How this helps Advisers

This rule of thumb helps advisers appreciate that some risk may be unavoidable, however choices can be made about which to accept. Apart from being useful for advisers, these are essential messages to communicate effectively to clients to ensure they correctly understand the implications.

By making sure clients appreciate how different risk types may impact outcomes, advisers are helping select the most suitable products for their clients and demonstrating how they are adding value.

References

- [1] Q. G. Rayer, "The alchemy of risk," *DISCUS*, 19 April 2018. [Online].
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- [4] F. J. Fabozzi, *Investment management*, New Jersey: Prentice Hall Inc., 1995
- [5] Q. G. Rayer, *Portfolio Construction Theory*, 5th ed., London: Chartered Institute for Securities and Investment, 2018

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