InvestSense

July 2022

Risky Business

Shopping for a new car, iPhone or laptop is a relatively straightforward affair. You generally know what you are looking for, you have a budget in mind, and you can set off on your search and narrow down the options quite quickly. Upon selecting the desired product of choice, you would have clear expectations around performance and function, which are captured in a product warranty.

Should any feature of your recent purchase fail to meet expectations there is a clear path to evaluate where your product has failed to deliver. In this case, the provider should hopefully back up their product with a remedy or a replacement. It's not always as simple a process as this, but for the most part, consumers are empowered to make choices, to evaluate performance, and have recourse should things not turn out as expected.

The investment industry does not work like this. The key distinction is that while the industry offers 'investment products' such as unit trusts, retirement funds and the like, it is in fact a service and not a product which investors receive. The main implication which we are focusing on here is that the investor assumes the risk of success, rather than the product provider. There is no recourse should a particular fund or product fail to meet expectations over time.[1]

This highlights the topic of "investment risk." Where the investor is taking on the burden of putting their own capital at risk to meet their objectives, guided and serviced by the industry, the concept of risk can be a vague and mis-used term which can serve to undermine good investment outcomes.

In the absence of a sound understanding of risk, it is likely that investors will be more conservatively invested than they otherwise should be. In the short term it may seem like this is a small trade-off, however it is only over extended horizons that this cost can be fully observed.

Simplifying Risk

To help ground this concept of risk, it is helpful to start by clearing up the use of the term 'risk'. For different participants risk can mean:

- The potential to lose money permanently. An example here would be through insolvency (African Bank) or even fraud (Steinhoff, or Ponzi schemes such as Sharemax). This is contrasted with losing money temporarily – a very normal occurrence in investing where share prices move up and down on a continuous basis.
- A length of time, where 'low risk' is often linked to short time periods such as 12 months, and 'high risk' is linked to long time periods such as 5 years.
- The variability of returns: how much portfolio values change each day, month, or year. Shares on the JSE for example fluctuate wildly compared with the return earned on a bank deposit.

The term 'risk' is often used as a catchall. Yet the three examples above have materially different interpretations and understanding the implications for each is critical to maintaining a proper investment plan.

Capital at risk

When we consider portfolio construction, we are assessing the potential to lose capital permanently. In a perfect world capital loss would be avoided in its entirety, yet this is probably an unrealistic expectation. With thousands of listed companies, debt instruments, property REITs and the like, there is always the potential for a company to face severe financial pressures which can result in capital loss.

So how can we mitigate this? There are several ways, the most effective of which is diversification. Spreading your capital over an extended range of assets, so that if any individual breaks rank it does not have an oversized impact on the total portfolio.

The second way we can mitigate this is by using strong investment managers who have robust research and due diligence processes

Contact Details
Phone: +27 10 020 6777 | Email: invest@investsense.co.za | www.investsense.co.za
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to mitigate or avoid any of these financial failures. With a properly diversified portfolio, the potential for small capital losses can be tolerated and offset with a much broader set of instruments which add value. And this is the key point: you need to be able to stomach some permanent losses to be able to access the types of investments which ultimately do the job of building wealth.

Over a 10-, 20- or 30-year investment horizon it is likely you will experience some permanent capital loss. It is worth pointing out though, that by far the biggest 'loss' would be an approach to investing which tries to avoid any form or loss whatsoever, and where the investor is underinvested in higher return assets such as shares for long periods of time.

Time is your friend

As an industry though we don't do ourselves any favours here. "Long term" is often perceived as five years for instance. This is not a long period of time: five years ago, we were uncovering the Gupta leaks, Jacob Zuma was still President and Steinhoff was about to make the headlines. Tested properly, "long term" should rather be defined as thirty years. This is a period which allows the short- and medium-term dynamics which shift portfolio values to average out to a more 'reliable' outcome – something closer to what a product provider offers with their warranty system. The trouble is, most investors are not aligned to this period of time in holding their financial service provider accountable.

More often it is short term, recent events which raise questions around performance. This can induce investment decisions without fully considering the real long-term implications.

It is easy to agree that longer term horizons are safer, or lower risk, than shorter term horizons, particularly when considering investments such as shares. The difficult part is acknowledging as such, and factoring this in when evaluating portfolio returns.

For instruments such as bank deposits or money market funds, there is relative certainty in terms of investment outcome over short horizons such as six or twelve months, which is distinct from the capital risk within (these assets are tied to just a handful of banks for example – a poorly diversified portfolio structure which would be higher risk in that sense).

What goes up does come down, and then goes up again

A particularly cryptic investment term is that of 'volatility'. Risk is often equated with this term to demonstrate how unreliable returns are. This is not really an accurate way to define risk either.

Given two options, which is the higher risk portfolio?

1. A portfolio consisting exclusively of rand-based loans to Eskom which only require paying back in a decade's time, or
2. a portfolio consisting of 2000 global shares ranging from Microsoft to Apple to Alibaba?

Eskom bonds run at around half of the volatility of the global equity portfolio. Does this mean they are half as risky? No, it doesn't. The diversification of a wide range of equities, held across different geographies and industries provides substantial risk management benefits, provided you have the longer-term perspective to recognize as such. Relying on a single issuer such as Eskom can spell disaster for an investment portfolio.

There are numerous other examples here as well: investors looking for low risk often end up invested in local income funds: where the return profile is consistent and appears to provide stability, ultimately the underlying assets rely on South Africa trading as a going concern, the rand maintaining a decent level of value, and the economy continuing at a sufficient pace to allow debt issuers to repay their loans. This is quite a narrow set of major events which all need to remain intact, unlike the global equity portfolio which can weather many a storm and still retain value for investors.

It is not the short- or medium-term variability of portfolio values which characterizes risk, but rather the likelihood that you, as an investor, get to earn the return you seek. The higher that likelihood, the lower the risk.

Beware the free lunch

Unfortunately, while the industry does not offer warrantees as standard fare on its investment services, it does tend to create attractive products which rely on the risk aversion/wealth seeking investor desires. Upside without the downside is the perfect sales pitch for any investor, but rarely does this ring true. Products such as hedge funds and many structured products can sound attractive at first, by promising positive returns without the downside. If this were the case, wouldn't all investor assets have migrated there by now? Most often the risks are just a little more opaque, and the costs higher, often offsetting what benefit there may be.

Living with risk

Back to our service versus product conundrum. The investment industry offers a long-term service, best measured over three decades to provide a warranty-level of comfort to investors. Investors are hoping for shorter term certainty and are often poorly communicated to by the industry.

This conflict is the source of enormous amounts of industry effort to help align expectations, but '*never the twain*'[2] shall meet. As service providers to investors, we can start by communicating better, and the topic of 'risk' is one such example of a potentially damaging concept which, when used without due regard for its impact, can cause harm to portfolios. Asking simple questions can help mitigate the real risk in investing:

- is my portfolio adequately diversified?
- do my service providers recognize the potential cost of being too conservative?
- am I being objective about my portfolio when markets are behaving erratically?
- do I fully understand the implications of changes I wish to make to my portfolio?

Better awareness of, and co-existence with, investment risk will result in better investment outcomes. Guaranteed.

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[1] We are talking generally around funds available to the investing public. This is distinct from the insurance industry, which offers a range of 'guaranteed' investment products where investors would have a minimum expectation given the terms of the product.

[2] Rudyard Kipling: The Ballad of East and West.

Contact Details
Phone: +27 10 020 6777 | Email: invest@investsense.co.za | www.investsense.co.za

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data provided by Refinitiv

MARKET REPORT

31/07/2022

		3m	YTD	1yr	3yr pa	5yr pa	10yr pa	5yr Vol1	10yr Vol1
LOCAL MARKET INDICES									
FTSE/JSE All Share Index (ALSI)	ZAR	-4.5%	-4.4%	4.7%	10.6%	8.2%	10.6%	15.7%	13.5%
FTSE/JSE SA Listed Property	ZAR	-2.4%	-5.0%	9.8%	-6.1%	-6.4%	2.7%	27.0%	21.5%
SA All Bond Index (ALBI)	ZAR	0.3%	0.4%	2.8%	6.9%	8.0%	7.0%	8.2%	7.9%
SA Cash Index (SteFI)	ZAR	1.2%	2.6%	4.3%	4.9%	5.9%	6.1%	0.4%	0.4%
Balanced Benchmark	ZAR	-1.5%	-4.2%	4.1%	9.4%	8.2%	10.5%	10.9%	9.1%
SA Inflation (1 month lag)	ZAR	2.4%	4.8%	7.4%	4.9%	4.7%	5.2%	1.3%	1.4%
GLOBAL MARKET INDICES BASED TO USD									
Global Equity (Datastream World)	USD	-1.2%	-13.9%	-8.7%	10.1%	9.4%	10.8%	16.8%	13.7%
Emerging Markets Equity (Datastream EM)	USD	-6.3%	-17.6%	-19.8%	1.3%	1.3%	3.2%	16.9%	15.7%
Global Property	USD	-4.0%	-13.1%	-7.3%	4.4%	5.7%	7.0%	16.4%	14.3%
Global Bonds (Barclays Global Bond Index)	USD	-1.1%	-14.9%	-17.8%	-3.1%	-0.6%	0.3%	6.6%	6.2%
Global Cash	USD	0.5%	0.7%	0.8%	0.8%	1.4%	0.9%	0.3%	0.2%
MAJOR INDICES BASED TO RANDS									
FTSE/JSE All Share Index (ALSI)	ZAR	-4.5%	-4.4%	4.7%	10.6%	8.2%	10.6%	15.7%	13.5%
Global Equity (Datastream World)	ZAR	4.1%	-10.2%	3.9%	16.2%	14.6%	18.9%	16.8%	15.2%
Emerging Markets Equity (Datastream EM)	ZAR	-1.3%	-14.0%	-8.6%	6.9%	6.2%	10.8%	14.0%	13.1%
Global Property	ZAR	1.1%	-9.3%	5.5%	10.1%	10.8%	14.8%	17.7%	15.2%
SA All Bond Index (ALBI)	ZAR	0.3%	0.4%	2.8%	6.9%	8.0%	7.0%	8.2%	7.9%
Global Bonds (Barclays Global Bond Index)	ZAR	4.2%	-11.1%	-6.4%	2.3%	4.2%	7.6%	15.6%	13.7%
COMMODITIES									
Gold (US Dollars)	USD	-7.6%	-3.2%	-3.2%	7.3%	6.8%	0.9%	12.8%	14.6%
Gold (Rands)	ZAR	-2.6%	1.1%	10.2%	13.2%	11.9%	8.2%		
CURRENCIES									
Rand / Dollar	ZAR	-5.3%	-4.4%	-13.9%	-5.5%	-4.8%	-7.3%	16.1%	14.8%
Rand / GBP Pound	ZAR	-2.1%	6.2%	0.3%	-5.3%	-3.1%	-4.6%	14.8%	14.6%
Rand / Euro	ZAR	-1.8%	6.4%	2.1%	-2.5%	-1.8%	-5.3%	14.2%	13.7%

Spot Rates		29-Jul-22	Latest Quarter	1 Year Ago	5 Years Ago	10 Years Ago	20 Years Ago
CURRENCIES							
Rand/US$	Rand	16.66	16.38	14.63	13.19	8.22	10.24
Rand/GBP	Rand	20.25	19.90	20.35	17.40	12.87	16.00
Rand/EUR	Rand	16.99	17.13	17.35	15.56	10.12	10.04
RATES							
Libor 6m $	US$	3.33	2.94	0.15	1.46	0.73	1.87
Repo Rate	Rand	5.50	4.75	3.50	6.75	5.00	12.50
Prime	Rand	9.00	8.25	7.00	10.25	9.00	15.00
All Bond Index Yield	Rand	10.83	11.05	11.64	9.39	7.05	9.74
COMMODITIES							
Gold ($/oz)	US$	1 764.24	1 806.87	1 823.24	1 268.85	1 621.25	304.85
Platinum	US$	889.00	907.00	1 044.00	938.00	1 427.00	529.00
Oil (Brent Crude) $	US$	110.06	114.93	76.47	52.49	106.53	25.80
INFLATION							
SA Inflation	%	7.4	7.4	4.7	4.5	5.0	9.4

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Email: adviser@fundhouse.co.za | Web: www.fundhouse.co.za