



LET'S TALK ABOUT...

FINANCIAL LEXICON EDITED BY THE SWISS ASSOCIATION OF ASSET MANAGERS

Risk free

(Part one) The term “*risk free*” is highly relevant in the financial domain and needs consideration by the private investor too, all the more in the current environment. It applies to those types of investments – or better, their rates of interest – usually belonging to the fixed-income instruments, which are issued by absolutely solvent entities, in a certain currency and with a defined expiration. Such financial instruments are supposed not to carry any credit (that is default) risk, due to their highest safety in terms of full reimbursement at due time. However the label “risk free” just refers to credit risk but not to interest rate risk, as a matter of instance. If between the times of their purchase and sale before expiration market conditions change, the price of proceeds may be lower than par value, so that the overall return may be less than initially expected. Neither “risk free” means the absence of reinvestment risk, as periodical coupons, if and when reinvested, may carry lower yields with them. It could be also noted that the safety of reimbursement at due time does not exclude repayments in devalued money compared with the time of investments. For the financial markets, “risk free” means a certain repayment of principal and coupons at due dates, and such concept is also important in creating a base for other evaluations. The yield of these ultra-safe instruments is a floor for calculating other products’ nominal or theoretical returns, both in the fixed income area as well as for other asset classes. Spreads are added to such base rate, according to the issuer’s category, its sector, dimension and financial reliability, the emission features and conditions and so on. The risk-free rate thus becomes a sort of benchmark for the whole financial market and may be even considered in assessing equity’ evaluations and finding out market “turbulences” and speculative bubbles. But a big and intriguing question arise at this moment. What is really “risk free” today? *(to be continued)* - GLT

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(Part two) In closing the previous article we wandered about what is actually “risk free” in the today’s financial environment, in terms of full absence of credit default or issuer’s risk. We have however noted that a possible “risk free” label does not exclude other risks: the interest rate risk, whose fluctuations affect the price of the instrument should it be sold before expiration, or reinvestment risk, for which periodical coupons may be necessarily replaced with lower returns. We have also discussed the importance of the “risk free” concept, as a base on which other relevant financial parameters are calculated, in the area of the fixed income sector, as well as for equity market assessments and other needs.

According to tradition risk free instruments are first of all supposed to be government issues with short maturities. Indeed sovereign issuers have been perceived by many as to be “above suspicion” in terms of financial reliability, unable to default and bankrupt due, among other reasons, to their unrestrained and exclusive privilege to print money in order to meet their obligations. Of course other related questions arise, as the level of independence of the involved central bank and the actual value of the money which is being printed.

But such rosy vision of the sovereign issuers, which by the way has proved pretty false throughout the centuries, is becoming more and more questionable again, after the recent financial crisis and their outcomes, including the excesses in public expenditures and debts. Sequences of rating cuts, skyrocketing CDS’s (that is the premiums for securing debt reimbursements at due dates), decreasing appetite of investors for public bonds, higher risk premiums and rates in general, all of that makes some affirm that completely and absolutely risk free instruments actually exist just in theory. By now the label may be applied to some market benchmarks, e.g. the US 3 months Treasury Bill or the German Bund and the Euribor rate. But if the investor looks to what happened in the monetary placement and interbank credit markets during the darkest moments of the financial crisis, in the aftermath of the Lehman tempest, or minds about the threatened downgrading of the US public debt itself (and it may be useful to remind that the US have already defaulted in 1933), not to say about the troubles and hyperinflations in Germany after the WWI, the risk free label for such items may be indeed less valid and wavering, to say the least. *(to be continued) - GLT*

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(Part three) Instruments, sovereign *par excellence*, being mostly issued by states and supranational institutions, which enjoy, when governmental, the exclusive advantage of un limited money printing by an agreeable central bank. Securities with short maturities, assumed as exempt from default risk, but not rate risk, that is possible price losses before expiration, as well as reinvestment risk of coupons proceeding, should market conditions be different. "Risk free" as an important base too in calculating other parameters in the fixed income, equity and other areas, as adding supplementary risks to other kinds of investments, their additional risks should be adequately rewarded.

But nowadays the concept of risk itself and its relation with expected returns are being turned updown by financial events, so that the "risk free" idea too is put into question due to the many and increasing troubles that many sovereign issuers are facing. The market is still taking the 3 month Treasury Bill as a "risk free" benchmark in the US dollar area, and the German Bund as its equivalent for the euro zone. But the US public debt is confronted with a downgrading threat and Euroland is stormed by debt and banking problems. May then be assumed that the "risk free" notion is at this point a just theoretic one? Unfortunately that seems to be the case, although subtle debates spread about the technical limits of the "default" concepts and complex solutions are designed in order to solve incurable situations. But new instruments and fresh environments do not make facts different for investors, as a best selling books shows with rich documental supports: it tells the story of state defaults through the time, collapses, financial crisis, hyperinflations and severe devaluations, some of them suffered but more often caused so to reduce debts to be repaid. Eight centuries of financial madness that Carmen Reinhart and Kenneth Rogoff discuss though the pages of their book "This time is different".

On the contrary the story always repeats itself and only "scripts" are sometimes updated. Losses are always born by savers and investors, in terms of actual defaults or devaluated reimbursements. And crisis more and more involve instruments which are perceived – and should be – highly guaranteed and above any suspicion, just exempt from any risk. (end)- GLT

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