



LET'S TALK ABOUT...

FINANCIAL LEXICON EDITED BY THE SWISS ASSOCIATION OF ASSET MANAGERS

Rethinking risk

(Part one) In the past years the traditional concept of risk (then safety in financial investments) has been turned upside down. If it is crucial for savers, consultants and portfolio managers to have a clear scale marking safe, pretty risky and speculative instruments, in many cases such marks have reversed or at least have become uncertain and less reliable. Actually assets which were supposed to be safer (e.g. sovereign debts of developed countries, property) have proved much more risky, and the riskier ones in theory (such as equity, commodities, structured and alternative products, including many survived hedge funds, corporate issues of smaller companies or emerging markets' debts) have showed much safer (and rewarding). Obviously such outcomes have also affected asset allocations and the way in which portfolios are designed according to the client's declared risk profile. Apart from invalidating the statistically based measurement of risk through the standard deviations of past assets' prices, so ignoring the low probability but high impact elements – the so called “black swans” after Nicholas Taleb – another dogma was undermined in 2008, the one of a positive correlation between higher theoretical risk and higher expected return. Even the most risk-free of all placements, that is holding cash in a current account, may be highly risky with the wrong bank, not to say about such low rates that may not cover the account expenses and fees, and inflation, making the overall result negative; but that is another story. And what about those money market funds, which are labelled as highly safe for clients and then happen to hold problematic paper and securities in their portfolios ? Real estate has always been the most solid and safest investment for excellence, but the bubble blow has cancelled such truth too, in the United States such as in many European countries, and it will take many years before prices reach their pre-crisis levels. But perhaps it was the sovereign bonds area which has experienced the wildest upsets, as we will discuss further down. *(to be followed) - GLT*

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(Part two) The recent upturn down in the perception – and reality – of risk, so that the supposedly safer investment instruments have actually become volatile and dangerous, whilst the asset classes traditionally assessed as more speculative and erratic in their values have proved more stable and rewarding, has widely and particularly affected the sovereign debt sector. Suffice it to look at the CDS's values in that area. If Greece was the first issuer to come under the spot, then followed by Ireland, the whole sector of sovereigns, with no exception, in Europe and the US, is faced with huge levels of national debts and deficits, and even more financially solid countries, such as Germany, are however linked to their weaker partners' destinies. So the historically safe investment is proving more and more fragile and it will be interesting to look at the levels of confidence and fidelization that traditional investors are going to show towards it. The same is happening in the currency market. The so called majors, that are the money of the more developed countries, are progressively loosing ground in favour of the secondary or even "exotic" ones. The euro is battered by debt and institutional crisis with no solutions in sight so far and the US dollar itself, although now supported by the extreme weakness of its global competitor, may not avoid the declared willingness to have it weaker on the long run, via the recent quantitative measures and so on. Investors, even if slowly and carefully, are modifying the currency allocations of their portfolios, by including larger and larger shares of secondary currencies, which are supposed to carry more appreciative – or at least less depreciative - potentials. All in all many emerging markets are now overtaking the developed ones, that is Europe and the US, in terms of currency, fixed income and even equity market opportunities. Another traditional "golden rule" according to which sovereign issues were safer than corporate ones has pitifully proven mistaken and within the equity markets the shares of small and dynamic companies are more and more often beating the traditional blue chips. It is a real revolution indeed and if we also consider the still uncertain trends in regulations and fiscal agreements with which Switzerland is faced, we can easily foresee further huge changes in the scenarios of asset allocation and portfolio management. *(to be followed) - GLT*

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(Part three) What was traditionally supposed to be less risky – e.g. blue chips, sovereign debt of developed countries, real estate – actually proved pretty riskier (and often less rewarding) than the presumed more speculative classes – e.g. corporate and emerging markets' issues, small-medium caps, commodities, precious metals, secondary and even exotic currencies. Such upturns down have obviously affected asset allocation and portfolio management operations: institutional and private investors are more and more moving assets from traditional placements to new areas, so radically changing the structures of their portfolios. It is a clear geographical switch, benefiting Asia and China specially, also thanks to the declared willingness of making the US dollar weaker in order to impose appreciations in the currencies of Asian exporters. Extremely low returns in the major currencies' markets (euro, USD and Japanese yen) just furtherly favour that trend. It could be discussed if such evolution is more cyclical or structural and definitive, but the analysis is out of our scope, at least for the moment. In the near future however, a low risk profile portfolio is likely to include commodities, corporate bonds, small caps and some survived hedge funds, able again to perform their institutional and original duty, that is generating absolute returns whichever the market conditions. But besides those risks, taking to changes which may be all in all seen as opportunities, other risks add up that may prove subtler and more tricky indeed, as the ones in the area of taxation, domestic and international laws pressured and applied to the Swiss wealth management industry, so to make decisions more complex and uncertain for investors and money managers, and their future even unforeseeable. *(end) - GLT*

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