Mind the gap – the risk to your portfolio

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The recent collapse of a number of energy companies demonstrates the perils, for the most part, of concentrating too much attention on just one aspect of an investment decision – the cost. With regards to investing, this incident highlights the important consequence of not assessing all inherent risks in making an investment decision and, by extension, managing a portfolio. In our unending pursuit of higher returns, whether that's through low-cost passive products, or investing in technology stocks, have we been ignoring these risks too long? Is now the time to balance risk with returns?

When a number of small energy companies began to pop up on high streets and in supermarket stalls, customers were instantly lured by their low-cost propositions. Fed up with the oligopoly nature of the big six energy companies, which tend to charge high fees, hundreds of thousands switched suppliers. This had echoes of all those individuals who took out Icelandic bank accounts in 2007, lured by high interest rates, and we all know how that turned out.

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Nearly 1.8m customers signed up to these energy companies, some of which have only been around since 2019. Sadly, a lot of them have now collapsed. Igloo, Symbio, Enstroga (who?), PfP, MoneyPlus, People's Energy (see what they're doing here?), Green Supplier Limited (well, if it has green in the name), Utility Point, Avro, with possibly more to come. Thankfully, customers will get a supplier assigned to them by the regulator Ofgem, so they will not be left without energy.

These companies were repeating the errors of the likes of Northern Rock in banking, in that they were lending long (signing up new customers) but borrowing short (buying energy at spot rates, rather than hedging their exposure). For both the banks in 2007 and energy companies in 2021, their business model was far more fragile than people (and the regulators) assumed.

A way to address this issue in investing is to ensure you follow a rigorous due diligence process, to avoid unpleasant surprises later. For example, a thorough due diligence may include the following risk factor assessment (amongst many more), all of which can take on a greater degree of importance in volatile markets:

1. Liquidity – in times of market stress, one can never underestimate the importance of being able to price and sell assets easily. Liquidating assets in a short period of time can be critical, as proven with the gating of property funds in 2008, or recently with Woodford's microcap holdings.
2. Concentration – the risk of being exposed to one counterparty
3. Counterparty – the risk that the other party in an investment or trading transaction will not be able to fulfil its part of the deal
4. Inflation – In the context of an investment portfolio, it is to stop or slow the erosion of value of investment
5. Interest rate – this is the risk to bond prices when rates rise and the older bonds with higher yields will have a higher sensitivity to rate rises causing their prices to sink
6. Currency risks – investments in other currencies run the risk of foreign exchange moves resulting in possible loss of money

In addition, reviewing all external risk factors such as macroeconomics, as well as microeconomic analysis of the company and its competitiveness, is also of paramount importance.

When constructing an investment portfolio, to avoid being hurt by all these risks at once, or to put it another way, to avoid all assets going down at the same time, we diversify risks by investing in assets, or investment products, with lower correlations to each other and the market.

Investing in a tracker product (either an ETF or a fund), say for example the S&P 500, provides direct exposure to the US market, and namely their most heavily traded stocks. The main risk here is market risk, which cannot be diversified away. This should be made clear to the investor at the onset. When markets rally, these investment products do well. However, on the flip side, and buyer beware, they will also deliver the same level of volatility as the market when conditions reverse.

All markets exhibit some form of volatility and, according to Collidr's proprietary methodology, generally fall into three categories or 'regimes' – low, medium and high. There are times when markets can move between these periods quite quickly. In the case of the S&P 500 (see table 1), the degree to which returns vary can be quite significant from one period or volatility regime to the next.

	Ann. Return	Ann. Std. Dev.	Ann. Sharpe
LOW	12.64%	12.14%	1.041
MEDIUM	13.16%	17.28%	0.762
HIGH	-19.01%	36.85%	-0.516

Table 1: The performance of the S&P 500 from 1 January 2005 to 15 October 2021, classified into three volatility regimes – Low, Medium, High. Data Source: Collidr & Bloomberg.

Given the recent events of March 2020, when COVID measures began to impact the markets, and in consideration of the Great Financial Crisis, have investors really learned this lesson, and are they prepared for the consequences if the markets move in the other direction? How robust is their portfolio, and will it be able to withstand similar events?

Depending on an investor's individual profile, if the objective is to protect capital, it is best to construct a resilient portfolio which seeks to limit this level of market reversal and drawdowns. This can be likened to portfolios where preserving capital is the main objective. It may mean limited upside participation, but the overriding goal is protection on the downside, applying a valuable hedge. Hedging of course is costly, but the point here is that sometimes costs reflect quality assurance.

The best way to demonstrate the quality of risk management, and robustness of processes, is to look at risk-adjusted returns. For instance, active funds may appear costlier at first, but depending on how they are constructed, and the role they play in the overall portfolio (their correlation to other investment products or assets), they may offset this additional cost by the protection they provide when markets are under stress, or when market conditions change. Ideally, resilient portfolios should have better risk-adjusted returns, and therefore a higher Sharpe ratio than the market and peers, to help limit drawdowns and lower volatility.

Just like a portfolio constructed to protect capital, it would have served energy companies well to hedge their exposure using futures to lock in energy prices over the long-term, helping them protect against price fluctuations. However, to attract and retain customers, and therefore grow, they skimped on this insurance to the detriment of their customers, and their business in the end.

As markets continue to rally, investors may continue to display a ‘herd mentality’ or ‘irrational exuberance ’, which might push prices even further still. Unfortunately, when everything continues to go up, this may result in a lighter approach to evaluating risk. Now may be an opportune time to take a step back and reassess how much protection a portfolio has, and how much risk it can tolerate. When it comes to this, assessing an investment product on cost alone is no guarantee of long-term performance or wealth preservation, nor should it be the only decision to make. Sometimes costs are higher for a reason, reflecting the need to actively manage risk in addition to seeking returns.