INSIGHT

THE GREATEST WEALTH IS **YOUR PEACE OF MIND...**

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What really is risk?

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One of the hardest concepts in investing is trying to understand what 'risk' really is and deciding how to deal with it. If you asked a fund manager to explain it to you, they would probably provide a lesson on credit, liquidity, and concentration risk (amongst many others) and the volatility of returns, as measured by the annualised standard deviation of returns! Viewing risk through that lens – and assuming you still had the will to live - you would probably come away thinking that cash is 'low' risk and equities are 'high' risk. Yet when you sit down with a good financial planner, they will be talking to you about a higher level of goals, such as living without worrying about money and having the freedom to do what you want, when you want. Risk, when looked at through this lens, should mean anything that makes attaining this goal less certain. In this context, cash may well become the 'risky' asset and equities the 'safe' asset.

Here's why: in a great little book titled Deep Risk by William Bernstein - a neurologist, a pilot and financial author – he separates risk into two key types: 'shallow' risk, which relates to the non-permanent, although sometimes extended, fall in asset value; and 'deep' risk which is the permanent loss of capital, through inflation, deflation, confiscation or destruction. If we avoid assets with uncertain short-term outcomes (diversified equities) in favour of those with more certain outcomes (cash deposits), we risk trading 'shallow' risk for 'deep' risk. Take a look at the chart below, which illustrates the likely permanent erosion of purchasing power of cash deposits, as a consequence of moderate inflation but low interest rates that we have experienced since the Global Financial Crisis in 2007-9.

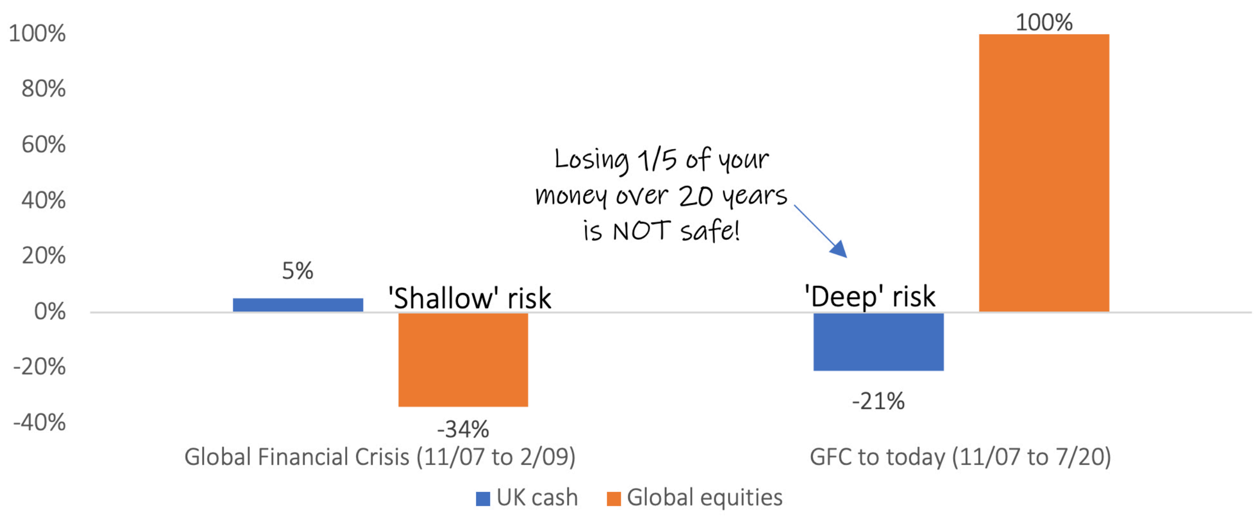

Figure 1: Cash can be a highly risky asset – cumulative real returns

Source: Morningstar Direct © All rights reserved (see endnote) UK One-month T-Bills (cash) and Global Equities (MSCI World Index).

Note that the returns are all calculated from the top of the market prior to the stock market fall. Unfortunately, many people with long-term horizons hold far too much cash e.g. around 45% of all money in ISA tax wrappers is in cash ISAs[1]. This phenomenon is often referred to as ‘reckless conservatism’. In investing, being patient and being brave pays great dividends for the long-term investor.

End notes

1. FT.com Popularity of ISAs drops to 18-year UK low Aug 31, 2018

Other notes and risk warnings

Use of Morningstar Direct© data

Risk warnings

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