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OPINION

Market Insight

We all need to reassess what we understand by the word 'risk'

The Covid-19 crisis has accelerated structural changes in the way financial markets work

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The global financial crisis of 2008, followed by the Covid-19 pandemic, has made fundamental changes to the way financial markets work. Interventions by central banks, designed to save economies from major dislocations, have shaken some of the basic concepts investors have been applying for decades. As a result, we need to revisit these ideas with fresh eyes and update them for a new era.

Consider one pillar of finance theory: portfolio construction. Harry Markowitz's Modern Portfolio Theory (MPT), conceived in the 1950s, was a dramatic leap forward in financial thinking, not only providing investors with a means to measure risk but also allowing them to quantify the marginal benefit of adding new exposures into a portfolio. But many of its assumptions are challenged in the current environment, where large-scale quantitative easing has changed the relationship between risks and returns.

The main concept that needs to be interrogated is the definition of risk itself. Historical volatility is often used as shorthand for riskiness in some popular models derived from the MPT framework. This is obviously insufficient. Risk cannot be reduced to one backward-looking statistic. It has to be about permanent loss of capital, which is the real threat investors face.

Moreover, it should be measured using a multidimensional approach that is linked to the current environment. The Covid-19 crisis is a case in point: investors were faced with new variables to assess, such as the contagion rate of the pandemic and the impact of lockdowns on the economy.

A second concept to revisit is the interplay between risk and return. After the massive evolution of fiscal and monetary policy that began in 2008 and accelerated with the Covid-19 outbreak, we are facing a regime shift that alters the pricing of risk in several important ways.

US Treasuries and government bonds from other highly rated countries are widely considered to be risk-free assets, as they are fully backed by the sovereign. This is true in a sense, as governments with top-quality ratings have always tended to pay back their debts in nominal terms. But it must not be overlooked that the purchasing power of those bonds is not guaranteed, due to inflation.

Furthermore, not only are government bond yields distorted by central banks' asset purchasing programmes, but so are the prices of stocks, corporate bonds and other assets. The expansion of central banks' purchases beyond government bonds has reduced the risk premium — or the excess return above the risk-free rate — embedded in virtually any asset.

Such purchases by central banks have positive short-term effects, preventing financial markets from freezing and allowing companies to access funds to support their operations. At the same time they create a self-fulfilling prophecy, as investors push up asset prices by trying to front-run the various programmes. But longer-term risks still rise in the economy, due to the misallocation of credit and increased solvency risk, as companies gain access to funding even as their cash flows dry up.

Regulatory risk is another factor to take into consideration. Governments are playing a bigger role in economies in response to the pandemic. They are taking a firmer grip on companies by providing the capital necessary for them to continue functioning.

Already, we are starting to see certain conditions that could affect companies' operations over the long term, such as the requirement that loan recipients forgo stock buybacks or cut dividends, particularly in industries such as utilities, automobiles and airlines.

Environment, social and governance risks, meanwhile, are becoming ever more important considerations for investors. Well before the current crisis materialised, we were living in an era of rising income inequalities and increasing urgency around the challenge of climate change. The Covid-19 outbreak has now brought us to a tipping point. We are witnessing a new regime, in which society will no longer tolerate these imbalances. Take Boohoo, the UK fast-fashion brand, which saw its stock drop about 40 per cent after allegations of supply-chain abuses caused several distributors to withdraw their support.

Companies that do not pursue sustainable practices on a day-to-day basis are creating real operational and reputational risks — at a time when new regulations can make or break entire industries.

That is why active risk management is vital to delivering consistent returns. By understanding and targeting risk in a measured, informed way, investors are building the foundation of future value creation.

As investors, we need to have the humility to accept that we can never be sure of any outcome.

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