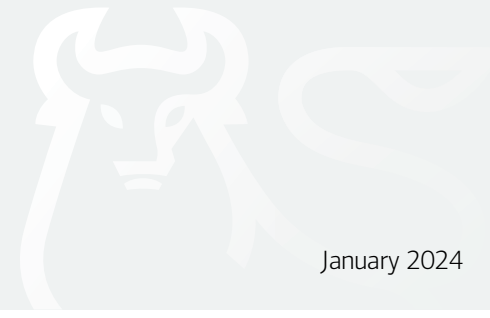


CHIEF INVESTMENT OFFICE

Educational Series



What is a “Risky” Asset and is Anything Really “Risk-Free”?

January 2024

WHAT IS RISK?

Risk is one of the top concerns for many investors. Investment risk is normally associated with the uncertainty and the potential negative effect on an investors’ financial assets. While we do not list all types of risks, to a certain degree, risk is involved in all types of investments. The level of risk often correlates with the potential of the investment’s return. The idea is that the tradeoff for an investment that might provide higher return is greater risk.

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WHAT ARE THE COMMON TYPES OF RISKS?

Equity investments, in the form of stocks and equity funds, are commonly perceived to be riskier than Fixed Income and in turn believed to carry greater potential for capital appreciation. However, there is a great diversity of risks within its subasset classes (see types of risks table on following page.)

Market Risk, also known as systematic risk, is one of the top risks that comes to mind when thinking about Equity investments. Beta is often used to measure market risk. A Beta greater than 1 suggests that the investment is more volatile than the overall market. Generally, market risk refers to the fluctuation of the value of an investment effected by market volatility, macroeconomic events, interest rate changes, inflation and so forth. **Macroeconomic Risk** is one of the key drivers of equity returns. Policy changes introduced by the government or industry-specific news may directly affect all companies and thus indirectly the stock share price. Within the subsectors of the Equity asset class, Emerging Markets (EM) could experience greater risks if the underlying countries in question have an unstable government or political unrest. EM investments are also typically affected by **Exchange Rate Risk** as those companies’ revenues are generated in foreign countries. Therefore, if the domestic currency depreciates relative to the foreign currency, the overall return of the investment may suffer.

Fixed Income is often used to diversify equity market risk and has historically had the potential to mitigate losses during market downturns. However, it certainly comes with a set of risks of their own. If an investor plans to hold a bond until maturity, **Interest Rate Risk** is generally not a concern. However, if an investor decides to sell the bond before it matures in the secondary market, then as interest rate rises, bond prices fall. This is because new bonds will be issued with higher rates making the outstanding bond less attractive. Bonds also run the risk of being downgraded by rating agencies such as Moody’s or Standard & Poor’s, which assess the quality and creditworthiness of the issuer. They are generally grouped as Investment-grade or non-Investment-grade (High Yield), and shifts from the former to the latter category can be viewed

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negatively. Different bonds might have different levels of **Credit Risk**. For example, U.S. Treasuries—backed by the full faith and credit of the U.S. government—typically have lower credit risk when compared to U.S. Corporates. Fixed Income investments also face **Liquidity Risk**. This is the risk associated with the inability to sell the investment quickly at a price that represents its fair value due to the lower demand. For instance, U.S. Treasuries are generally more liquid than U.S. Municipals.

While Cash might be perceived as a “safe haven” to park assets, it is actually riskier than investors may think. We may wonder if there are better places to allocate the funds, one where higher returns could be achieved—**Opportunity Cost Risk**. Additionally, it is important to highlight that in an environment of rising interest rates and high inflation, Cash tends to lose its value over time.

Types of Risk	Risk Descriptions	Examples of Effected Asset Classes
Market Risk	Systematic risk. Uncertainty of investment value due to volatility.	Equities
Macroeconomic Risk	Changes in industry and government policies effect all investments.	Equities, Fixed Income
Exchange Rate Risk	Unfavorable movement of exchange rates reduces value of the investment.	Emerging Markets
Inflation Risk	As price of goods and services increase, investors lose purchasing power.	Fixed Income, Cash
Interest Rate Risk	As interest rate rises, bond price and value fall.	Fixed Income
Credit Risk	Greater business and financial risks cause issuer’s credit to deteriorate.	U.S. Corporates, High Yield
Default Risk	Issuer defaults on their obligations.	High Yield
Liquidity Risk	Inability to sell the investment quickly.	Alternative Investments
Prepayment Risk	Issuer of investment repays principle prior to maturity.	U.S. Mortgages
Reinvestment Risk	Reinvesting cash from existing investment at lower rate.	U.S. Mortgages
Opportunity Cost Risk	Losing out on potential gains.	Cash, U.S. Government

Source: Chief Investment Office.

HOW CAN WE MITIGATE RISKS?

Investment professionals often use hedging as a strategy to help mitigate risk. While hedging may help to reduce risk and potential losses, it could simultaneously reduce the potential upsides. Hedging techniques often include the use of derivatives such as options and futures. Asset allocation and diversification are also investment strategies used to mitigate risks in portfolios. Within Equities, it is possible to allocate across various sectors, styles, industries, countries, and thus exposing ourselves to different types of risks. In Fixed Income, a mixed exposure across bond issuers, durations, credit qualities, and yields could also reduce the risk of the overall portfolio.

IN CONCLUSION

While techniques exist to help mitigate various forms of risk, no investment, including Cash, is really risk-free. Instead, investors should thread the right balance between their financial circumstances, risk tolerance and time horizon when making investment decisions.

Glossary

Systematic risk is vulnerability to events which affect aggregate outcomes such as broad market returns, total economy-wide resource holdings, or aggregate income.

Beta is a measure of how an individual asset moves when the overall stock market increases or decreases.

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