

RISK an Old Age Phenomenon

Let every man divide his money into three parts, and invest a third in land, a third in business, and a third let him keep in reserve. – Talmud (Circa 1200 B.C. - 500A.D.)

The above quote is approximately 2000 years old, but whoever said it knew something about risk, return and diversification. In fact, he may have been the first advocate of Asset Allocation.

A more modern definition of Asset Allocation would be: the strategy of dividing your total investment portfolio among various asset classes, such as stocks, bonds and money market securities. Effectively, asset allocation is an organized method of diversification. The rationale behind this technique is such that, a portfolio of different kinds of investments will, on average, yield higher returns and pose a lower risk than any individual investment found within the portfolio. In essence, the positive performance of some investments will neutralize the negative performance of others.

Before you allocate assets to your portfolio, you need to determine: your risk tolerance, investment objectives, time horizon for which you are looking to invest and your available capital. Needless to say, each individual will have different needs and tolerance levels. Equally important, is knowledge of the risk- return characteristics of various asset classes and sub classes. For instance, Equities tend to be the most risky asset class and as such have the highest potential for returns. However, we can break this asset class down further into sub classes based on market capitalization value: Large-Cap Stocks (market capitalization greater than \$10 billion); Mid-Cap Stocks (market capitalization between \$2 billion and \$10 billion) and Small-Cap Stocks (market capitalization less than \$2 billion).

Large-Cap stocks tend to be the least risky type of equity, as these are shares issued by large well established companies and the likely hood of these companies failing is minimal. Examples of these companies on the local market include: RBTT Financial Holdings Limited, Republic Bank Limited and First Caribbean International Bank. Mid-Cap stocks tend to be more risky than Large-Cap stocks and represent the shares of mid-sized companies. Examples include: ANSA Mcal, Guardian Holdings Limited and Sagicor Financial Corporation. While, Small-Cap stocks represent smaller sized companies and are usually the most risky type of equity investment, mostly due to lower liquidity. Examples include: National Flour Mills, Angostura Holdings Limited and Unilever Caribbean Limited.

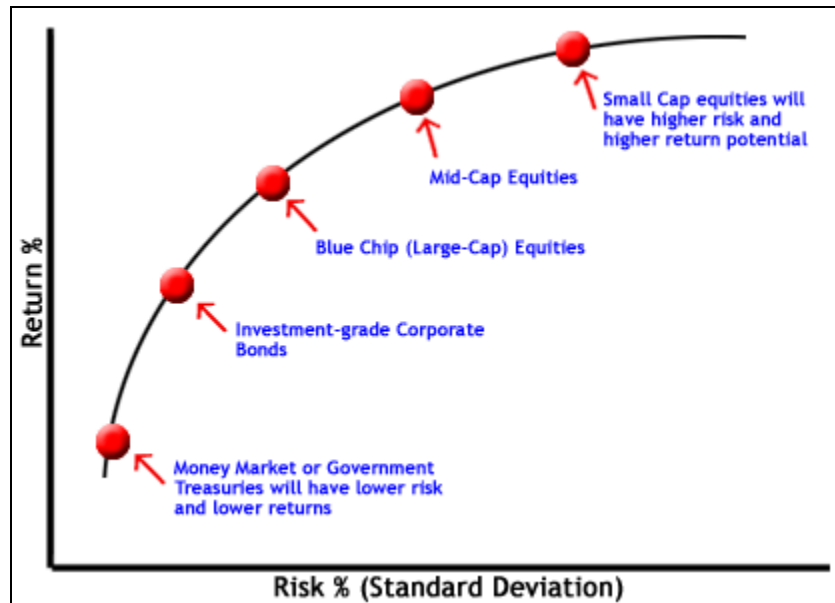
While, Equity Investments carry a high level of risk, Fixed Income Securities and Money Market Securities carry a low level of risk. Fixed Income Securities comprise debt securities and carry a lower level of risk when compared to equities, because the owners of such securities receive predetermined fixed periodic payments in addition to return of principal at maturity. Generally, these types of assets offer a lower return on investment because they guarantee income. Examples of Fixed Income Securities include: corporate and sovereign or government bonds. Money Market Securities, are also debt securities,

but are very liquid investments with maturities of less than one year. Treasury Bills make up majority of these types of securities.

Chart1 Illustrates the Risk Return Relationship of the asset classes mentioned above.

Source: www.investopedia.com

Chart 1



Portfolios can then be designed based on the preferences of the investor and can range from conservative to aggressive in terms of risk. For instance, an investor who is risk averse and prefers to protect the principal investment value of his or her portfolio will allocate a large percentage of the total portfolio to lower risk securities such as, fixed income and money market securities. Although the conservative investor may prefer not to invest in the equity market, it is advisable that they allocate at least a small portion of their portfolio to this asset class, as this may help to hedge against inflation. . Such that, in times of rising prices, the real rate of return received on fixed income and money market securities, will not be as high as initially expected. For Example, an investor may invest in a bond that pays 10% coupons, however if the rate of inflation is 4% then the investor's real rate of return is in fact 6%. While, inflation does not have much of a direct effect on the stock market, since over the long run, a Company's Revenue and Earnings should increase at the same pace as inflation. The "conservative" investor may want to invest in Large-Cap stocks as these can have the effect of diversifying the portfolio into equities but at the same time minimizing risk within the asset class.

On the other hand, the more risky or aggressive investor will have the opposite portfolio allocation. This type of portfolio will have a majority proportion of Equities and a small proportion in Fixed Income Securities and Money Market Securities. In the short term, the value of these portfolios will fluctuate widely; however, the objective of an investor with such a portfolio should be long term capital appreciation.

The “conservative” investor and the “aggressive” investor can be seen as two extreme scenarios. Thus, it should be noted, that there are investors who fall in between these extremes and portfolios can be modeled to suit them. Models can be fine tuned to meet various needs. For instance, investors who need liquidity and safety in their portfolio will put a larger portion of money market instruments or short term fixed income securities.

Additionally, once you have chosen and constructed your portfolio, it is important that you review the values of your assets as these will change and can affect the weighting you desire. For instance, the equity portion of a conservative portfolio may increase significantly during a year and the portfolio will have more weighting on this asset, which making the total portfolio more risky. In order to rebalance your portfolio, you will need to sell off those assets which have increased significantly and use those funds to buy additional units of assets which have declined slightly or increased at a lesser rate. The Rebalancing Process can also be used if your investment strategy or tolerance level has changed.

Achieving your optimal asset allocation is a proven strategy for maximizing returns while minimizing risks. Whether you are aggressive about risk, conservative about it or fall somewhere in between- you can create a portfolio that will match your needs. Once you have created your portfolio, you can maintain the balance or change the mix if your tolerance levels and investment objectives change. Ideally, the concept of asset allocation is one of the best investment strategies any prudent investor could take...after all, it's been around for ages!!