RISK PROFILE AND TIME FRAME
the building blocks of a successful portfolio

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Investors today face an enormous range of choices

Technological development is advancing at a rapid rate and the amount of information we have at our fingertips is phenomenal. As consumers, we can do and buy virtually anything online – including investments. However, the range of choices on offer can be overwhelming, especially when it comes to investments.

The South African retail unit trust industry alone consists of close to 1 500 funds spread across 32 different fund categories. This is an enormous number of funds to consider and the sheer magnitude often causes investors to procrastinate. The problem is that when it comes to investing, you want time on your side.

Fund categories can be defined by what you can expect from the following three positively correlated measures:

1. **return;**
2. **risk** (characterised by volatility of returns and the probability of capital loss); and
3. **time.**

To increase your potential returns, you need to accept a higher level of risk and stay invested for longer. If you need to access your money within a short time frame, you need to either accept the risk of capital loss to maintain high return potential, or lower your potential returns and invest in a lower risk category.

The ratio of interest-bearing assets (cash and bonds) relative to growth assets (equity) allowed within each fund category determines its return, risk and time frame profile. In general, interest-bearing assets offer consistency and capital protection, but lower growth potential. Growth assets, on the other hand, offer much higher growth potential over the long-term, but also higher volatility and risk of capital loss over shorter time frames.

The value of investing in the appropriate mix of fund categories

Achieving your savings or investment goals starts with determining an appropriate mix of fund categories for your unique financial needs. Key elements of this phase of financial planning for financial advisors are matching investors' needs and requirements to the appropriate fund categories, and managing expectations throughout the respective time frames.

To illustrate the value of being invested in the appropriate mix of fund categories for the appropriate time frame, we have analysed the average return of the ASISA (the Association for Savings and Investment South Africa) fund categories across the risk spectrum for the period of July 2000 (the common inception period) to date.

The table below shows a few key points from the results:

- For each fund category, the number of rolling periods where the category exceeded its return target increased as the time frame increased.
- For each time frame, a higher return expectation and risk exposure reduced the number of rolling periods where the return target was exceeded. In other words, increasing return expectations without increasing the time frame reduces the chance of success.
- The number of rolling periods where the categories exceeded their return target is more than two-thirds for each category's appropriate time frame (highlighted in green in the table). Given that this is based on a category average and does not include the additional value-add of manager selection, more than two-thirds is a good ratio.

FUND CATEGORY	INTEREST BEARING: GROWTH ASSETS [1]	SUITABLE TIME FRAME	SUITABLE RETURN EXPECTATION	HIT RATE [2] SINCE JULY 2000			
				1 YEAR	3 YEARS	5 YEARS	7 YEARS
Money Market	100:0	< 1 year	CPI	75%	81%	100%	100%
Multi Asset Income	90:10	1-3 years	CPI + 1%	75%	81%	100%	100%
Multi Asset Low Equity	60:40	3- 5 years	CPI + 3%	64%	68%	71%	70%
Multi Asset High Equity	25:75	5-7 years	CPI + 5%	59%	65%	67%	62%
South African Equity	0:100	> 7 years	CPI + 6%	60%	67%	68%	68%

Source: Morningstar Direct

[1] Ratio as per maximum equity exposure allowed per ASISA category
[2] Percentage of rolling 1, 3, 5 and 7 year time frames for which ASISA category average outperformed the appropriate return expectation

An easy way to illustrate the value an adviser can add by helping you invest your money appropriately across the fund categories, is to illustrate the impact an inappropriate of inefficient fund allocation can have.

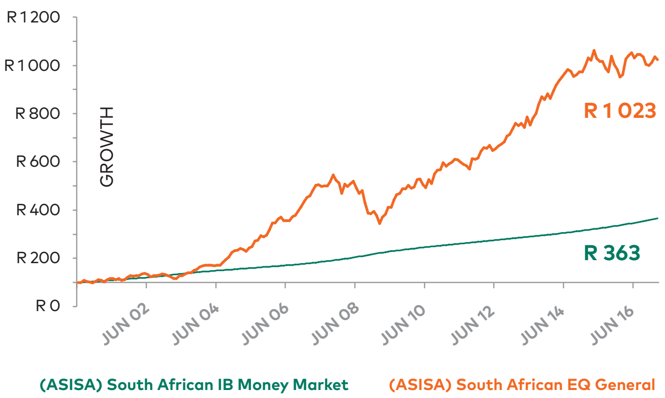
Case study 1:
Too little risk over too long a time frame

Let's first look at the opportunity cost of not taking enough risk on the portion of your savings where you have time on your side. The graph below illustrates the extreme case of being invested in money market instead of being invested in the highest risk and growth potential asset class – equity. As the graph illustrates, every R100 invested in money market would have grown to only R363, whereas a R100 investment in equity would have grown to R1 023. This is an opportunity cost of 6.4% per annum.

The same holds true for all the fund categories. As expected, the table below illustrates that, as you move up the risk spectrum from a multi asset income fund to an equity fund, annualised growth (and volatility) increases. Consequently, the opportunity cost of not accepting higher risk than that of money market (which is seen as the closest proxy for risk-free) in your investment portfolio, also increases.

Growth on R100 invested in June 2000: cash vs equity

Source: Morningstar Direct



This also applies to shorter periods. The table below illustrates the number of rolling periods for which each fund category (within its appropriate time frame) outperformed money market as well as the average annualised reward for accepting additional risk.

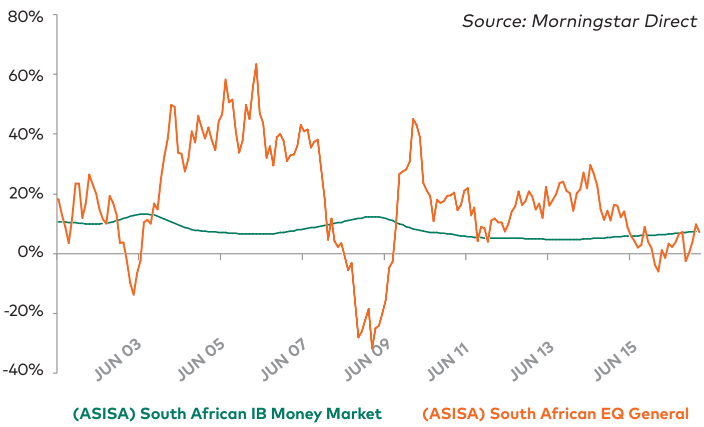
	MONEY MARKET	MA INCOME	MA LOW EQUITY	MA HIGH EQUITY	SA EQUITY
Annualised growth	8.0%	9.7%	10.8%	12.3%	15.0%
Annualised volatility	0.6%	2.6%	3.8%	8.6%	13.4%
Annualised outperformance to money market		1.5%	2.5%	4.0%	6.4%

		MA INCOME	MA LOW EQUITY	MA HIGH EQUITY	SA EQUITY
Rolling 1 year	Hit rate vs Money Market	77.8%			
	Average annualised outperformance	1.3%			
Rolling 3 year	Hit rate vs Money Market	77.6%	77.0%		
	Average annualised outperformance	1.1%	2.6%		
Rolling 5 year	Hit rate vs Money Market		83.7%	86.5%	
	Average annualised outperformance		2.5%	5.3%	
Rolling 7 year	Hit rate vs Money Market			100.0%	100.0%
	Average annualised outperformance			4.4%	7.5%

Source: Morningstar Direct

Case study 2:
Too much risk over a short time frame

Higher risk is, however, not always the right answer. Let's use a 1-year savings goal as an example. Even though equity can, and often does, outperform money market over a 1-year period, it is not an appropriate fund category to use for short-term goals. The graph below illustrates why.



Over our 200-month sample period, the money market did not deliver any negative 1-year returns, while equity reported negative returns 25 times, with the biggest loss being -32.9%. Equity also underperformed money market 54 times over a rolling 1-year period. The level of underperformance ranges between -0.3% and -37.3%, with the average loss being -12.5%.

The same is true for all the fund categories. As you move up the risk spectrum, the number of rolling 1-year negative returns and underperformance relative to money market increases; so does the extent of capital loss and underperformance.

ROLLING 1-YEAR PERIOD	MA INCOME	MA LOW EQUITY	MA HIGH EQUITY	SA EQUITY
% Negative returns	0%	1%	9%	13%
Greatest capital loss	N/A	-1.3%	-14.7%	-32.9%
< Money Market	22%	22%	29%	29%
Underperformance range	-0.05% to 4.40%	-0.10% to -11.68%	-0.02% to 23.86%	-0.76% to 39.45%

Source: Morningstar Direct

One can almost compare constructing an appropriate portfolio to Goldilocks' search for a chair, porridge and a bed that is 'just right'. Unfortunately, however, when it comes to investing, the stakes are higher. As illustrated in this article, trying 'too cold' and 'too hot' before getting it 'just right' comes with great opportunity cost or capital loss. ■