Atkins Bland
Investments • Pensions • Financial Planning

Guide to:

Reflecting Time Frame in Investment Risk Strategies

An overview of our approach and the rationale behind it

Introduction

As discussed in our Guide to Investment Risk, there is a direct relationship between investment time frame and investment risk.

In general terms, and providing a wide spread of different investments, the longer the time frame, the less the risk and the shorter the time frame, the more the risk.

This is because a short time frame may not allow markets time to recover from a crisis while a long enough time frame should.

In addition to this relationship, there tends to be a correlation between risk and return. A more volatile investment normally has a reasonable prospect of rewarding the investor with higher returns than a less volatile option.

The logical conclusion from this is that it makes sense for time horizon to be carefully factored into any investment strategy, so that:

- a portfolio that is expected to remain invested for a long time is designed to incorporate more allocation to the investment areas which could produce the best longer-term results, since there is plenty of time to ride through any bad patches.
- a portfolio with a shorter time frame is structured to have less exposure to these areas since, if a market crisis comes along, there may not be enough time to await a recovery before investments have to be sold.

It is important to note that the above refers to markets overall, or funds that are spread across markets, rather than to individual investments in, for instance, the shares of a single company.

The risk characteristics of a single share are different since there is always a possibility of a company failing and the shares becoming worthless.

This level of risk does not usually exist with a fund spread across a wide number of shares, since the failure of one of the companies would normally only have a modest impact on the value of the entire investment.

Reflecting the above core factors, Atkins Bland applies a process that takes these observations into account in our advice.

We do this by considering first where a client sits on the investment risk ladder in terms of their overall attitude and preferences, but suggesting they consider moving up or down this ladder based on the following criteria relating specifically to the possible time period before investment may need to be sold:

More than 15 years:	Consider moving up the risk ladder.
Less than 5 years:	Consider moving down the risk ladder.

Why 15 years?

As you move up the risk ladder, the main change is to increase allocations to sectors showing the highest shorter-term volatility in capital values and reduce exposure to those expected to show lower volatility.

Generally, this translates to increasing equity (stock market) exposure and reducing exposure to bonds (fixed income securities), real estate and infrastructure.

We have carried out detailed research to assess the time frame needed, based on past records, for a well-diversified portfolio allocated to the world's stock markets to have always achieved a gain rather than a loss. This does not guarantee the same will be true in the future, but we believe it represents a rational way to assess how investment risk is impacted by time.

To do this we initially looked at the past results at rolling quarterly intervals, every year since the end of 1989 up to December 2016, thereby capturing the huge rise and fall created by the "dot.com bubble", which burst in March 2000, as well as the Financial Crisis in 2008.

The data showed that, since the end of 1989, a globally diversified equity portfolio allocated in a way that created a realistic proxy for our client's equity allocation over the years has consistently generated positive returns over a time frame of 15 years.

The data also showed that, over a 15-year time period, our global equity allocation proxy had consistently outperformed a cash-only portfolio.

We updated this research in January 2023, but simplified the process by using a portfolio consisting of an equal allocation to the 6 main equity market regions, using the following Investment Association (IA) sector averages (priced in GBP): UK All Share, North America, Asia Pacific ex Japan, Japan, Europe ex UK and Global Emerging Markets.

This is less representative of our past advice as we normally recommend a higher allocation to the UK than to any specific overseas market, in the interests of risk control for a Sterling based investor.

However, a higher allocation to overseas markets than we would normally recommend increases the validity of the analysis rather than reduces it, as it assumes more is invested in higher risk markets than we would normally apply.

This adjusted process also showed that the portfolio had produced positive returns over every rolling 15-year period.

Data using 10 years created the same outcome, but we work with 15 years to err on the cautious side.

We then compared the results from the equity only portfolio with the traditional structure for mitigating equity risk, using 40% allocated to bond markets, which we represented by using the IA Global Mixed Bond sector average. As that sector came into being in 1994, we could not go back earlier than that.

The following graph shows the comparison between these two strategies:

In essence, while excluding the bond allocation creates a great deal more volatility, it also creates a significantly enhanced total return over the longer period.

Our conclusion from this is that, where there is an available time frame of fifteen years or more, the conventional thesis that a portfolio should hold non-equity assets to mitigate risk appears invalid, and that a strategy based on this approach is likely to hinder performance rather than mitigate long term risk.

We therefore feel that, given the historical precedent, where a portfolio is expected to remain in place for at least fifteen years and there is no expectation that the money will have to be withdrawn prior to that, it is appropriate to move up the risk ladder to a strategy that either reduces or eliminates that allocation to one or more of the risk-mitigating asset sectors.

It is important to emphasise that anyone choosing to apply this process is not losing access to their capital for fifteen years since the investments can easily be sold. However, the process is based on the understanding that the portfolio can be left in place if market conditions dictate that this is sensible so there is no expectation of a forced sale at an inopportune time, such as shortly after the markets have suffered a crash due to an unforeseen event.

Why 5 years?

With a short timeframe, we have the opposite scenario, as this raises the risk of market volatility having a larger impact. Indeed, if time frame is very short there is a risk that a portfolio experiences a sharp fall due to a market crisis of some sort and there being inadequate time to await a recovery before the investments must be sold.

The conventional thinking is that where money is being invested in assets where values fall as well as rise there should ideally be an expectation that it is able to remain invested for at least 5 years.

We have tested this using data from FE Analytics, going back as far as we can, which is to 1989, and this does show that the longest period before a market crash has been followed by a full recovery is less than 5 years.

We therefore feel setting the threshold for considering moving down the risk ladder purely to reflect a short time frame at 5 years is rational.

The value of past records

While past performance records applied in the way we have here can be very informative, they cannot be relied on as an accurate indication of what the future holds.

This needs to be remembered when considering the option to use our long-term strategy with money that seems suited to this, as the conclusions from our research might not prove valid as the future is revealed.

It is also worth stating that this uncertainty works the other way too, and the traditional strategy of using bond markets or other non-equity sectors to mitigate stock market risk might not work effectively in the future.

Discretion over the timing of withdrawing from a portfolio

This is a core factor in assessing risk.

If someone should have plenty of discretion over when money is withdrawn from their investments, then the risks posed by an unexpected market crash are mitigated, since there is increased potential to sit tight and await a recovery.

The reasons for a decision to withdraw from an investment portfolio can vary widely, but an actual need to do so usually only applies if the money is required for expenditure of some sort and other money is not available. If money is not actually needed for expenditure, then any decision to withdraw from investments is likely to be a discretionary decision.

To help ensure this discretion is available, it is wise to keep an adequate "rainy day" fund in an easy access deposit-based account of some sort, or in Premium Bonds.

In terms of considering time frame with invested capital, it is the issue of a possible necessary sale of investments, rather than a possible discretionary decision to sell, which is most important.

A discretionary decision is only relevant if it might be made even if market conditions are poor, and it is important to retain enough in deposit-based investment to cater for any such decision.

Important notes

Any opinions expressed on the merits or disadvantages of any options are intended as a general comment only and not as specific advice to the reader.

This document is intended as a supplement to full independent advice and not as a replacement for it and should be read in conjunction with any personalised recommendations provided by Atkins Bland Ltd and with any product brochures supplied.

The value of investments will fall as well as rise, as can any income produced.

Inflation can reduce the real value of capital and the income it generates

Past investment performance is not a reliable guide to the future

Any reference to taxation, regulation or legislation is based on our current understanding and details should be checked before any reliance is placed upon its accuracy.

The impact of taxation and tax planning depends on individual circumstances and may be subject to change, which can be retrospective.

Errors and omission excepted

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The value of investments, as well as the income generated, can go down as well as up and an investor might get back less then they invested.

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