Investments • Pensions • Financial Planning

Guide to:

Risks of Static Risk Classifications

Introduction

This guide is supplementary to our main Guide to Investment Risk, available on request. Its purpose is to look at the problems surrounding the common practice of operating with static sector risk classifications.

There is a tendency in the financial services industry for risk classifications for different sectors to be practically fixed and to take no account at all of prevailing valuations or other variable factors.

This has led, for instance, to funds invested in gilts or high-grade corporate bonds to be classified as lower risk or at least no more than below average risk and nearly every investment linked to an overseas equity market to be classified as either above average or high risk and for these classifications to remain in place year in year out.

We consider that this has always been a deeply flawed approach. In reality, the risks associated with an investment depend not only on the nature of that investment but also on a range of other factors and, particularly, on prevailing valuations and economic conditions at the time the risk is being assessed.

To give two simple examples of why this standardised thinking doesn't work properly:

- If a particular market sector has risen substantially and is at the highest point it has ever reached using appropriate measures, then it probably has a quite significantly higher level of risk than has applied at other times.
- In contrast, if that same investment sector had just suffered a substantial fall which had taken it below any previous valuation levels then its downside risk would surely be considerably lower than the normal case.

We do not believe that a rational argument can be made against this premise. We do, therefore, feel that sector risk classifications should be looked at in a more sophisticated way than the financial services industry tends to apply. Risk classifications should be dynamic and should be regularly reviewed to take proper account of all relevant variable factors.

Atkins Bland has, for the above reasons, stated in our documentation for many years that we are quoting a "current risk classification" for each sector or fund since we recognise that the risk classification is likely to change over time and may move either upwards or downwards.

To apply suitable portfolio management it is important that risk is assessed and kept under review and that this does take account of current risks rather than a risk classification which may be entirely out of step with prevailing conditions.

We therefore operate a process designed to assess the current risk classifications of each sector and apply this as a fundamental mainstay of our core portfolio review processes.

By doing this we seek to ensure that the risk characteristic of our clients' portfolios remain where they are supposed to be and do not drift off target due to changing market or economic conditions.

However, while clients using our pro-active review service can rest assured that we always apply processes to reflect the dynamic nature of investment and financial risk, we have prepared this guide to aid an understanding of why and how the risk attached to a particular type of investment might change over time, perhaps dramatically.

As well as aiding an understanding of our thinking and the philosophy behind our advice, this guide may be helpful in allowing someone to assess the risk they are exposed to with their investments not being looked after by Atkins Bland.

Defining our phraseology

The wording we use to define risk and what we mean when we use it

For portfolios, we use the following risk classifications:

High
Above average
Average
Below average
Low

Clearly, as with any terminology to describe investment risk it is important that everybody understands what the phrases refer to.

To help address this issue, for investment sector risk and investment fund risk we use this scale:

Nine
Eight
Seven
Six
Five
Four
Three
Two
One

Whether using "average" or "balanced" or "medium" or "Five" it is important that the person reading the document containing the word understands what is meant by it. We aim to create a distinction between an "average" risk portfolio and a fund with an individual risk score of "Five" in order to demonstrate that, whilst we believe, for instance, a fund scored "Eight" may be suited for inclusion in an "average" portfolio, the fund may be quite volatile and may rise and fall more than the overall portfolio. We do, though, aim to balance portfolio risk, and to factor in issues of correlation, so while fund risk scores are always considered when constructing portfolios, the relationship between different funds making up the whole portfolio is perhaps of even more importance.

It is also important that downside risk is given more attention than upside potential, since decisions should be made with regards to tolerance for risk rather than attraction to gains.

Our approach to this is to define risk with reference to our expectation of the probable largest fall from an investment in the relevant category over a twelve-month period.

This does not mean the largest fall which can occur within a twelve-month period but the largest fall from the start of a twelve-month period to the end of the twelve-month period.

We are not, therefore, taking full account of very short-term changes or "flash crashes" such as have been seen in some markets due to problems with the computerised trading mechanisms.

Few people should have investments outside deposit accounts which are expected to remain in place for less than twelve months so looking at the potential downside over a full twelve months is an appropriate measure.

Our risk parameters

How we categorise investments to define their risk characteristics

As a starting point, we need to understand what range of change in value should be considered as probable. In establishing what we mean by "probable" we have applied a measure based on our actual past experiences looking after clients' portfolios for well over 30 years.

During this time, we have seen a wide range of political and economic events and technological developments which have created some substantial volatility.

These include, but are not limited to:

- The UK privatisation process and the advent of Mrs Thatcher's drive to "wider share ownership"
- The 1986 "Big Bang" when electronic share trading was introduced in the UK
- The 1987 crash
- The 1990/91 Gulf War
- The September 1992 "Black Wednesday" exit from the ERM
- The 1997 Asian Crisis
- The 1998 Russian sovereign debt default
- The 1997 to 2000 dot.com boom and bust
- The 2001 "9/11" attacks (and a range of other terrorist atrocities since then)
- The 2003 Gulf Wars
- The 2008 US subprime collapse and the ensuing Financial Crisis
- The 2010 European sovereign debt crisis
- The 2015 Chinese stock market crash
- The 2020 Outbreak of the Coronavirus pandemic

There have also been numerous changes which were not represented by an event but by progress and development, such as the opportunities and challenges created by the industrialisation in China, bringing with it massive changes in commodity prices and global trade.

We consider the range and nature of these events and developments has enabled us to develop a very good understanding of the probable worst-case scenario for asset values during a crisis or over a given time period.

This history also shows that the probable worse-case scenario in terms of a fall in the value of an asset is impacted quite heavily by the prevailing valuation level and the economic climate.

Our risk parameters

How we categorise investments to define their risk characteristics

However, it is important to have a general starting point in terms of defining our points of reference. Based on history, we consider referencing the events listed earlier is both relevant and rational.

Applying this methodology, we consider a sensible way to define the different risk classifications we use in terms of either an individual investment or a broad portfolio of investments is as follows:

Risk classification	**Largest probable loss (taking account of any income generation) over a full 12 month period**	
	Individual investment in a single sector	Portfolio spread across different sectors
Low	15%	10%
Below average	25%	20%
Average	40%	30%
Above average	75%	50%
High	No limit	60%

The reason the figures for individual sector risks are so high is that we are looking at estimated worse case scenarios during an extraordinary event.

The reason the single sector maximum estimated losses over 12 months are higher than those for a portfolio in the same risk category is explained by the risk mitigation achieved by diversification.

The extraordinary events which might cause a very harsh fall might reflect a prior absurd overvaluation (such as technology and telecommunications shares during the ‘dot.com’ bubble and broad market valuations in 1987)

They may also reflect a sudden and substantial negative shift in the economic climate, such as we saw at the start of the Financial Crisis and when Covid 19 unleashed its havoc on the world.

It is never possible to predict these events with confidence, but it is important to be mindful that the risks of a sudden reversal exist and to operate systems which seek to identify where the risks lie and take these into account in portfolio strategies.

This is where recognising that risks change over time, and are not static, is so important,

It is not the remit of this guide to go into any detail on all the processes we apply to achieve this ambition, and since these in themselves must be dynamic to reflect ever changing global financial, political and economic conditions, doing so would involve a very lengthy document.

It is, however, helpful to set out, on a sector-by-sector basis, some examples of how and why sector risk classifications might change, and take the reality well outside normal expectation or accepted viewpoints.

Examples of the different risk classifications of different sectors

How traditional sectors risk classifications can be compromised by variable factors

Sector	Traditional thinking on risk classification	What could make it higher	Notes
Cash deposits	Zero	Hyperinflation, currency collapse, corporate failure without access to a compensation scheme	Risk is not just about a nominal value. If a Pound today was worth the equivalent of 50p in a year due to a combination of a currency collapse and consequent high inflation, it has lost 50% of its value, even though it is still called 'one Pound'.
UK bonds	Low	Same as with cash, but also a large rise in interest rates	Bond values are linked to interest rates. They usually go up when rates fall, but down when they rise. If interest rates are very low, bond risks must have risen.
Overseas bonds	Below average	Same as UK bonds, but with the added ingredient of currency change	If the pound rose against the USD and Euro, overseas bond funds would tend to fall in value to a UK investor.
UK equities	Average to above average	Stretched valuations following a bubble	With a portfolio of equities, the risk is about overall valuation levels. While individual shares also carry the risk of complete loss from corporate failure, the entire market cannot experience this without an Armageddon event, which is not included as a risk item in this table.
Overseas equities	Above average to high	Same as UK, but with added currency risk	
Specific sectors (e.g. technology, financials, commodities, healthcare)	High	Stretched valuations and sector specific issues	Risks differ by sector but we have seen the banking sector collapse at the start of the Financial Crisis, Technology shares collapse due to 'over exuberance' and commodities due to massive changes in supply and demand.
Real estate	Below average	Stretched valuations, interest rate rises, economic slowdown	The main risks to real estate valuations are when values become too high to be sustained, following a bubble.

Our conclusions

Our thoughts on risk classifications

While it is easy to believe that nothing we are used to will change much, history is awash with evidence that this is highly unlikely to prove true.

We believe that, with hindsight, some of the widely accepted views on the risks attached to different investment sectors will be revised.

Reflecting this, we believe it is very important to try to anticipate where the dangers and opportunities lie from shifting risks classifications in different sectors.

As valuations change and the future unravels, the issues and factors defining the risks and opportunities of different investment sectors will inevitably alter.

As they do, so too will the investment advice we give to our clients.

Incorporating an ongoing review process based on holistic thinking about where we are and where we are heading has always been important, and the provision of this service is the prime mission of Atkins Bland Ltd.

We hope this guide setting out some of the factors, issues and views behind the reason we do what we do is of help and interest.

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

Prepared by Atkins Bland Ltd. October 2021

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The value of most investments will fall as well as rise, as can any income generated. An investor may, therefore, get back less than invested.