Timing Markets and Managing Risk

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It seems to be commonly known that there's a bubble in sovereign bond markets that is going to burst, and that the six-year bull market in equities can't go on for much longer. Surely it's time to take your profits?

It's hard to argue with this sentiment, but it would also have been hard to argue with it at the start of 2015. Anyone who did the 'prudent' thing and exited markets then would have lost out on over 20% growth on euro equity markets and around 13% on longer dated euro government bonds during the first quarter of 2015.

What many investors don't understand is that trying to time markets significantly adds to investment risk rather than reducing it. If you get it right you will be handsomely rewarded; if you get it wrong, you will pay dearly.

Take a look at two investment options over the last 20 years – international equities and government bonds (for ease of research I have used Friends First's International Equity and Fixed Interest Funds as proxies for these markets). Equities would have delivered you a return of 333% and government bonds 288%.

If you tried to time the market on just four occasions moving between equities and bonds and got it spot on during the dot-com bubble and the financial crisis you would have seen your returns balloon to 2,739%; but if you got the timing of those four switches spectacularly wrong you would have lost 41% over the period.

So two asset classes in isolation provided similar enough returns over the last 20 years, but trying to time the markets could have resulted in a spread of returns between -41% and +2,739%. Now that's increasing risk!

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Timing markets has its place, but is managing risk one of them? Experience has shown us that investors can benefit from having the mental strength to commit to markets for the long term, but also the foresight to ensure they are adequately diversified across different investment types. There is now a wide choice of target risk multi-asset options available to help investors do just that.

We have had multi-asset funds in the past but the big difference with the new breed is that they tend to be managed to maximise returns within risk constraints as opposed to traditional 'managed funds', which seek to maximise returns without formal risk parameters.

Although the objectives of the newer generation of funds may have changed many will be managed in a similar style to the traditional 'managed fund': that is, they rely on the skill of the fund manager to assess the risk/return potential in different areas of the market and make asset allocation calls as they see fit. This is a very valid and logical approach but it must be recognised that it does increase the market timing element of the long list of risks that need to be considered.

Another approach is to rely more on longer term strategic asset allocation. Here you are recognising that over time most asset classes perform, but different asset classes perform at different times. So rather than trying to anticipate market movements, you recognise that all asset classes will have periods of negative performance but you compensate for this by ensuring you have included lots of different types of investments capable of performing in different market conditions.

As with most things, the decision on which tack to use is not a black and white call, more a matter of emphasis.

At Friends First, our successful Magnet range of portfolio funds has just celebrated its fifth anniversary, providing investors with strong risk appropriate returns. In managing Magnet, and its sister range of Compass funds, we would place more emphasis on the latter approach. We think we can help manage risk by ensuring we have lots of different moving parts in our portfolio funds. That's not just different asset classes: it is also different asset managers with different ideas and different investment strategies including absolute return. We don't consider these funds as just multi-asset funds – they are multi asset; multi-manager; multi-strategy portfolio funds!

As we get more comfortable with the new world of target risk funds I think it is incumbent on advisers to ensure that they understand the different approaches being adopted by the different portfolio fund ranges on offer – they are not all the same. Unfortunately as to whether an emphasis on tactical market timing or longer term strategic asset allocation will deliver the better risk appropriate returns – well, only time will tell.