



Investment Insight

Friday, 26 May 2017

Risky business. Investing is inherently about taking risk. Some risks can be avoided – foreign currency risk for example – but other risks are unavoidable. The level of unavoidable risk generally correlates with the prospective returns on a given investment which is why equities, for example, generally offer higher returns than government bonds. The same is true for corporate bonds, property, venture capital and everything else generally referred to as “risk assets.” Even government bonds with longer maturities than T-Bills generally have to offer a higher yield to compensate for the risk of inflation and rising interest rates.

As a result, probably the most important question in determining the long-term returns investors can earn is how much risk they are prepared to take. In **The Inside Track**, we share some clear thinking on the matter from GMO’s Ben Inker.

The times they are a changin’. At the beginning of the 20th century virtually no one had driven a car, made a phone call, used an electric light, heard recorded music or seen a movie. Clearly a lot has changed in the meantime and, as you would expect, the nature of the global corporate landscape has changed also with it. In 1900 with the UK at the helm of a powerful global empire, the UK stock market was the largest in the world, dwarfing the likes of the US and Germany. However, that was all about to change, and in this week’s **Pic of the Week** we look at what evolved.

Quoted...

“...” – Marcel Marceau

The Inside Track

Ben Inker is head of GMO’s Asset Allocation team and member of the GMO Board of Directors. The following are some interesting extracts from his recent paper on the issue of investment risk.

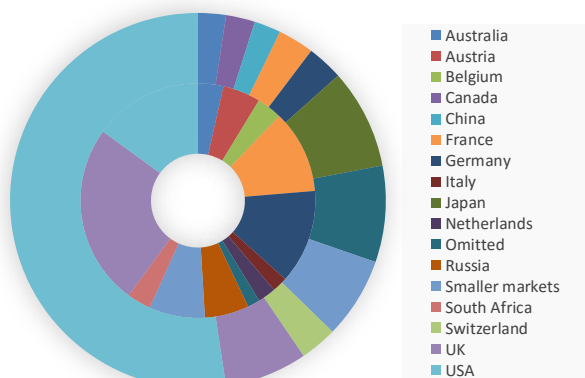
Determining how much risk you can take as an investor is a crucial exercise. There are at least two aspects to it, generally referred to as risk capacity and risk appetite...Risk capacity refers to the extent of loss a person or organization can withstand without having to significantly change spending patterns...A 25-year old who is 40 years from retirement probably has more risk capacity in his retirement savings than a 70-year-old who relies on those savings for a large portion of his necessities.

An investor who has much less risk appetite than risk capacity will wind up leaving a lot of return on the table over the years for no good objective reason. But the converse problem is quite real as well. An investor who sold risk assets in 2009 due to heightened fears of depression or just the shock of the losses suffered in the financial crisis clearly held a portfolio too risky for his risk appetite, regardless of his true risk capacity...I believe you need to worry about both a few risks that are eternal – the risk of depression and the risk of unanticipated inflation come to mind as eternal risks – as well as risks that come out of the unique economic, political, and environmental issues that are specific to the world today.

Most of the time, hedging and asset shifting decisions are not easy and involve trade-offs that have real costs to them, either in terms of lower expected returns or worse returns in a scenario that we may well care a good deal about...Our goal is to improve our expected outcomes in the events we fear without paying too large a price in lower expected returns or increased risks against other scenarios. This is not always possible, and when it isn’t, we’ll suffer some insomnia. Losing sleep isn’t fun, but overpaying for sleep aids will wind up hurting in the long run.

Pic of the Week

With the rapid evolution of new technologies, the potential for global power shifts is greater than ever. But even at the relatively slower pace of the last century of so, there has been much evolution in global stock markets. Early in the 20th century, the US overtook the United Kingdom to become the world’s largest stock market. For a brief period in the late 1980’s Japan took on the mantle, before handing the baton back to the US where it remains today. The chart shows the power shift from 1900 (inner circle) to today (outer circle).



Market View

	Last 7 days	Last 12 mths	YTD	5Y Ann.
Global equities	+1.4%	+16.0%	+7.7%	+10.9%
US equities	+2.1%	+15.5%	+7.9%	+12.9%
European equities	+0.8%	+13.0%	+8.1%	+9.6%
EM equities	+1.7%	+25.7%	+16.6%	+2.2%
Irish equities	+1.5%	+7.7%	+7.0%	+17.7%
Commodities	+1.2%	+2.5%	-3.5%	-8.6%
Hedge funds	+0.4%	+6.8%	+2.3%	+1.8%

Economic indicators	Bond yields	Inflation	GDP YoY
Ireland	+0.8%	+0.9%	+7.2%
Germany	+0.4%	+2.0%	+1.7%
USA	+2.3%	+2.2%	+1.9%
China	+3.6%	+1.2%	+6.9%

Currencies	Current	YTD Δ
EUR:USD	1.12	+6.6%
EUR:GBP	0.87	+1.5%
EUR:CNY	7.70	+5.0%
GBP:USD	1.29	+4.8%
Bitcoin	2,706.74	+184.3%

Week ahead: Key events

30/05 Japan Jobless Rate & Retail Sales
30/05 Eurozone Confidence Data & Germany CPI
31/05 UK Consumer Confidence
31/05 Japan Industrial Production & China PMI
31/05 Eurozone CPI
01/06 Japan PMI & Eurozone Manufacturing Data
01/06 US Employment
02/06 Japan Consumer Confidence & US Non-Farm Payrolls

Commodities	<i>Current</i>	<i>YTD Δ</i>
Gold	1,255.09	+8.9%
Copper	5,662.50	+2.5%
Oil	53.53	-8.8%
Wheat	434.75	+0.1%

Central Bank rates	<i>Current</i>
Eurozone	0.00%
USA	1.00%
UK	0.25%

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