Five Questions

Episode Four | Risk Management

Pete: Hi, my name is Pete Mann, and I'm the President and Co-CEO of Grayhawk Wealth. Welcome to the second season of our podcast, Five Questions, which will see one partner at Grayhawk, paired up with another to touch upon relevant topics as they relate to the economy, investments and generally what's happening in the world as we see it. Sometimes we'll invite special guests to join us so you can also hear their views. With me today is Greg Gipson, Grayhawk's Chief Investment Officer, who is responsible for shaping our investment philosophy and portfolio strategy. Welcome, Greg.

Greg: Thank you, Pete. Great to be here, and I have to admit, the topic of conversation today is one of extreme interest that I have.

Pete: That's great. Well, that is right. So today, Greg and I are really excited to talk about risk management. It is not typically something that people get excited to talk about nor hear much about, but it is an extremely important element to the process of allocating capital and organizing your investment decision making processes. Greg, I've heard you say multiple times that risk is the one true constant in investing. What do you mean by that?

Greg: I feel that maybe we should set this on a loop and just include it in all of our podcasts. But I firmly believe in investing, you know with absolute certainty that any investment you will incur some level of risk and you aspire to realize a level of return that compensates you for taking that risk.

Pete: Yeah. So true. So true. So, look, let's delve right in. People often refer to volatility as risk. Are they the same things or is volatility just an element of risk?

Greg: In financial services, financial markets, the two terms are often used interchangeably, and they're related but they're not exactly the same. Volatility in financial markets is simply the variability of price, so how much does the price of an asset change over time. Risk in a real sense, is a measure of how much any individual is willing to lose in order to potentially win or gain return. And each individual's appetite for risk or appetite for what they are willing to bet is unique. And there's a fascinating field of study this harkens back to my, you know, 25 years ago now in grad school, studying decision theory, decision analysis, focused on probability and statistics. So, if you think of it in this way, you know, where risk is, what you're willing to lose, any time you make an investment in reality, the risk is you could lose everything. Through the life of that investment, you realize some level of variability of returns for which you aspire to be compensated for in the form of return and there are very different concepts applied to public markets and private markets. So, if you think of the example of private markets, and we've spoken about this before, where the level of volatility or price variability is lower than public markets, in reality, your risk or what you could lose can be much higher. In some ways, volatility is the path that you take. Return is where you want to get to, risk is having the wheels fall off the car when you're on the journey.

Pete: You know, it's interesting Greg, one of my mentors used to always say to me, investing is about probabilistic risk reward using partial information. So, a lot of what you're referring to, you never actually get to see the full page. The amount of work that you can do determines how much of the page you either are given or can see. But ultimately, there is always some component of the decision-making process that that holds risk. And so invariably, as you said, the basis can be that you could lose everything, but the work itself and the probability set allows for a much greater sense of comfort as it comes to deploying capital in terms of risk. So, Greg, maybe moving on just a little bit. What do you wish people better understood about risk management and maybe some of the elements that make it optimize?

Greg: First and foremost, in investing, it's always important to remember that there is no free lunch. So, if something seems too good to be true, it probably is, or it's merely being explained in a way that makes it look better. So, there is honesty and then there is distrust and there's shades of gray in the middle. And so, when you think about how investments are also often presented, there's all these fancy ratios, but what you're really doing, what investing really is, if you break it down to its, you know, principal component, it is buying return for a unit of risk. So how much return are you compensated for, for taking a level of risk. Those ratios are ways of getting to that objective, but there are many ways to make those numbers look better than they are.

Pete: Sure. You know, it's so interesting because you see people all the time refer to returns in almost their absolute state. And one of the things that I know you and I both see on a very common occurrence is that they believe that all returns are made equal, essentially comparing what we might do to construct a portfolio versus something that is constructed completely differently, generating a higher or lower return. And the fact of the matter is, is that these pieces, the element of depth of understanding is so essential to being able to make better capital allocation decisions. And quite often it's hard to make that discussion point relevant for people because it's not how they think about things. As you always talk about, they think in return space, not in risk space and return space for most people, is this absolute number. This is what I earned and how they got there is almost irrelevant. So, Greg, one of the most common forms of risk that people often refer to, especially in this day and age, is FOMO or the fear of missing out. We know it's certainly not exclusive to investing, but could you describe a little bit about the challenge that it has had on long term returns for most investors?

Greg: There's never a dearth of acronyms to simplify very complex decision making. And when you think of FOMO or fear of missing out from a financial market sense, it's really a measure of momentum and even outside of financial markets, it's really a measure of momentum. And when you think about that, you know, how does that impact people psychologically? It really fits into what we would classify as an opportunity cost, so the cost of not being involved. So, psychology basically fear of missing out or FOMO makes one feel like they're losing money. For long term investors, the short-term fear of missing out short term momentum trades really is less of an issue. And most academic papers and of course, we always reference the academics who are always accurate in what they espouse. Multiple academic papers have pointed out that what's important is time in the market and not timing the market. The real challenge that investors face is when they chase returns, because if they chase them on the way up, they're more than likely to chase them on the way down.

Pete: Thanks very much for that, Greg. I'd love to talk a little bit about what often feels like quite a technical term, but risk budgeting. Maybe you could talk a little bit about what risk budgeting is and how is it determined and monitored.

Greg: Well budgeting is an interesting concept, and often you'll hear that it's a, quote, new concept when in reality it's not. So, think about back to our first podcast this season when we spoke about, you know, capital allocation versus risk allocation and how that can really determine how you construct a portfolio. So, when you look at risk budgeting, what is it? Well, it's really a means of allocating dollars or allocating capital based on the volatility of an investment rather than a static percentage of assets in a portfolio. Where it becomes a bit more complex, which is why I find it super interesting, is there's much more complexity, much more mathematical complexity when you allocate based on risk rather than on dollars. And the reason that is, is that thinking in dollar space is very easy. So, you just take a percentage of your dollars, throw it in investment, call it a day. It's a linear or a straight-line allocation of capital. Risk is non-linear. And from a behavioral perspective, a psychological perspective, it can be very challenging to think in non-linear space because while dollars are constant, percentages are constant, volatility, and here we get to throw out fancy terms like time varying or volatility clouds but volatility changes over time, which means how you allocate dollars in a risk budgeting perspective is time varying or changes over time based on the variability or volatility of the prices of the underlying investments.

Pete: Okay, Greg, our final question of the day. What is the most common risk that people overlook in investing in an everyday life? That would be the first part of it. And then maybe why don't you touch on, as we all have, what would be one or two of your biases as it relates to risk and investing?

Greg: Conceptually, one of the largest challenges people can often face in investing and in everyday life is understanding the difference between probability and possibility. So, any outcome is possible, but many outcomes have very low probabilities or very low chances of occurring. So, if you think of a classic example talking about crosswalks. So, the numbers will tell you that more people are injured in crosswalks than anywhere else on the street. So, a simple answer would be well, why would you ever cross the street in a crosswalk? Just do what every early morning commuter does in downtown Toronto, jaywalk. However, you need to understand not the possibility, but the probability and the probability deals with numbers. So even though the largest number of people may be injured in the crosswalk, that number relative to everybody who uses crosswalk globally is quite low. So, you have a possibility of an event, but a very low probability.

Pete: Yeah. You know, the other example that I've often heard relates to dying in a plane crash. And if you think about the likelihood of a plane going down is extraordinarily low. Thus, the chance of dying in a plane crash is extraordinarily low. But when a plane crashes, the probability or likelihood of death is near certainty.

Greg: There's a whole host of decisions that people make every day that is probability versus possibility. Even walking out the door, getting in your car, commuting on the DVP, there are any known number of possibilities, but very low probabilities of outcomes.

Pete: So true. So true. Okay. Thanks very much, Greg. Well, that's it for this episode of season two of Five Questions. I'm Pete Mann, President and Co-Chief Executive Officer of Grayhawk. On behalf of my partner, Greg Gipson, our Chief Investment Officer. We want to thank you very much for listening. We'll be back in two weeks with a new episode This podcast is for informational purposes only. It is not meant to be relied upon for investment or tax advice. It is the opinions of those on the podcast and does not necessarily reflect the opinions of Grayhawk Wealth. If you'd like to offer any feedback or pose a question for inclusion on the podcast, please reach out to our Chief Experience Officer, Allison Comeau at acomeau@grayhawkwealth.com. We look forward to chatting again in a couple of weeks.