Risk – downside protection

In this edition, we consider market risk and how you can set up your portfolio to give yourself the best possible chance of outperforming in a market downturn. This is known as downside protection.

Sometimes, the macroeconomic environment will go against you. Whether it is fears over a China slowdown, a banking crisis or a collapse in the oil price, there will always be something on the horizon that could trigger big market falls. In the past 12 months we have seen a few such events. They have been followed by indiscriminate sell-offs in almost all sectors, with prices tumbling sharply.

While these falls are an inevitable part of investing, you can protect yourself to some extent. With smart asset allocation, you can put yourself in a good position to potentially fall less than the wider market. This way, when the market bounces, you may be rising from a higher level.

REDUCE YOUR EQUITY EXPOSURE AND DIVERSIFY

Investors wishing to reduce their risk should consider diversifying some of their equity holdings into other investments. You could hold a variety of asset classes such as bonds; infrastructure; property; cash; absolute return (a type of fund that will try to create a return in all market conditions); and even gold (see page 22).

Adding these types of assets can help reduce the overall risk of your portfolio in two ways. Firstly, funds such as low risk absolute return, high quality bonds or even cash are typically less volatile than equities. Secondly, some of these assets are uncorrelated or lowly correlated with equities. This means that if the market tumbles, they may fall less or they may even rise. Of course, it's important to understand these assets could also fall as much or even more than, the market, but the point is they provide diversification because there is minimal connection between their movements and the broader stock market.

Recently, correlations between asset classes have been increasing and this has made constructing portfolios more difficult. Bonds and equities used to behave very differently, for example, but now their performance can be quite similar. The prices for perceivably 'safer' assets, such as government bonds, are also high at the moment. Some assets that typically remain relatively uncorrelated to equities are physical gold, cash and certain types of absolute return funds[1].

DEFENSIVE FUNDS WITHIN EACH ASSET CLASS

You can also help protect your portfolio by choosing more defensive funds. Some equity funds have a bias to cyclical industries such as banks, which are dependent on the economy. These funds are more aggressive and are likely to fall more than the market during a sell-off, but rise more than the market on the way up.

Conversely, there are funds that invest in more defensive non-cyclical industries, such as utilities or healthcare. Specialist equity infrastructure funds are another example. Typically, these funds will be less affected by the wider economy and will therefore fall less than the market in the case of a sell-off. They do, however, tend to lag if the market rises quickly. Investors wishing to reduce risk could consider adding some of these more defensive funds into the equity portion of their portfolio.

For bonds, consider high quality, low duration funds that are less sensitive to changes in interest rates. You could also look at certain strategic bond funds that have the tools to react to changing market conditions.

GO GLOBAL

You can also diversify globally. Investors typically have a home nation bias, but by spreading assets across different countries, you become less exposed to the risk of one currency or country. The Brexit vote aftermath has shown how important this is, with many overseas funds taking large jumps in sterling terms following our currency drop.

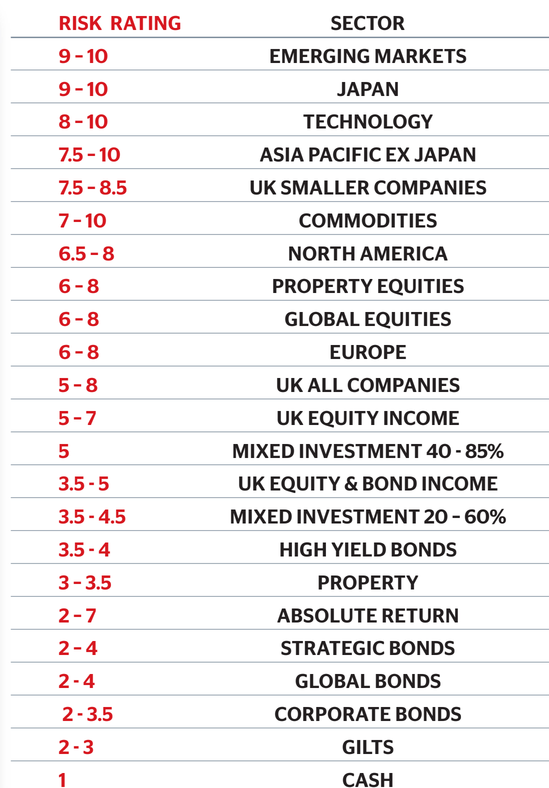
The US dollar is typically treated as a 'safe haven' asset, which will offer some protection in times of market uncertainty.

Always remember that the mix of asset classes in your portfolio and the percentage you allocate to each will depend on your personal attitude to risk and return. Consider what level of equity and other exposure you are comfortable with before building or amending your portfolio. If you require individual investment advice you should contact a financial advisor.

HOW TO USE THE CHELSEA RISK RATING

The Chelsea Risk Rating is simply a generic guide to the **relative** risk of funds within the market. It is up to you to determine your optimum asset class mix. The Chelsea Risk Rating is shown in the form of a thermometer (below) and is based on our in-house research.

The Chelsea Risk Rating attempts to quantify the relative risk of funds, to give you an idea of how risky one fund is versus another. A fund rated 5, in the middle of the spectrum, does not mean it is suitable for medium-risk investors, merely that according to historic volatility, and our understanding of the manager's investment process, we think it is more risky than a fund rated 4 and less risky than a fund rated 6. **Even funds rated 1 are subject to risk.**



CHELSEA RISK THERMOMETER

RISK RATING	SECTOR
9 - 10	EMERGING MARKETS
9 - 10	JAPAN
8 - 10	TECHNOLOGY
7.5 - 10	ASIA PACIFIC EX JAPAN
7.5 - 8.5	UK SMALLER COMPANIES
7 - 10	COMMODITIES
6.5 - 8	NORTH AMERICA
6 - 8	PROPERTY EQUITIES
6 - 8	GLOBAL EQUITIES
6 - 8	EUROPE
5 - 8	UK ALL COMPANIES
5 - 7	UK EQUITY INCOME
5	MIXED INVESTMENT 40 - 85%
3.5 - 5	UK EQUITY & BOND INCOME
3.5 - 4.5	MIXED INVESTMENT 20 - 60%
3.5 - 4	HIGH YIELD BONDS
3 - 3.5	PROPERTY
2 - 7	ABSOLUTE RETURN
2 - 4	STRATEGIC BONDS
2 - 4	GLOBAL BONDS
2 - 3.5	CORPORATE BONDS
2 - 3	GILTS
1	CASH

[1] FE Analytics, Bloomberg Gold Sub vs MSCI World vs MSCI United Kingdom vs Bank of England base rate correlations. 06/09/2001–05/09/2016. Data accessed 06/09/2016