How to think about risk late in the market cycle

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Feeling squeamish as we see volatility in stock markets after recently posting new highs? Anxious about the length of the current economic expansion? You’re not alone. Many of us are wondering if the time has come to de-risk our investment portfolios.

Maybe it is, maybe it isn’t. The important thing is to think clearly about risk. Too many people hear “de-risk” and think they must run for the hills. They forget a simple concept: “De-risk” does not mean “no risk.”

When we talk with our clients, we frame the conversation around three key concepts:

- Risk tolerance: the willingness to take risk
- Risk capacity: the ability to take risk
- Risk required: the level of risk required to meet a particular goal

Too often people focus exclusively on risk tolerance. When markets go up, people tend to want to take on more risk, and when markets go down, people generally want less. In effect this may lead us to buy high and sell low.

Is risk required to meet your goals?

Most goals require some level of risk, but how much? Ask yourself, first, what are you trying to accomplish with your money—what dollar amounts will be needed for which goals? Over what time horizon will they be needed? And, finally, how important are those specific goals—essential or optional?

To put these issues in a late-cycle perspective, we look at three different investor profiles. Take the case of a 27-year old saving for her retirement 40 years down the road. Because her retirement is so far off, she has substantial risk capacity. She could choose to be fully invested and not have to worry about de-risking her portfolio because over long periods of time, markets tend to go up.

But the story is different for a 62-year old nearing retirement who is fully invested. His risk capacity may be much lower because once he retires, he’ll be living off of his investment income. An ill-timed market drawdown could be a real problem, and so a conversation about de-risking makes a lot of sense. Another challenge he may face is the forced need to sell stocks at an inopportune time, perhaps to raise cash for spending needs. Of course this may also create an unwanted tax liability! As such, it might be worth considering a line of credit, which can allow him to meet his liquidity needs without the pitfalls.
Our third investor is 80 years old, with a net worth that vastly exceeds his modest annual spending and puts him on track to meet his financial goals. On the one hand, he has a very high risk capacity. But on the other hand, his required risk is low—he doesn't really need to take risk given his financial situation. So his investing decisions may be a simple function of his risk tolerance, or his willingness to take risk.

Market cycle highs and lows can be particularly damaging for such an investor when decision-making becomes hostage to behavioral biases. This is where predetermining buy/sell rules can be critical—and where ensuring regular check-ins with a trusted collaborator can help.

You can manage risk both inside and outside the investment portfolio

When considering your risk tolerance, risk capacity, and risk required, it's important to remember that you can make decisions both inside and outside your investment portfolio to manage your overall risk. Inside your portfolio, you may choose to increase allocation to a specific asset class or sector to dial up, or down, your risk exposure. Outside your portfolio, you may choose to make a lifestyle change to save a certain amount of money to use toward one of your goals.

For example, say you're working toward the goal of sufficiently funding the retirement lifestyle you want to have. If you are able, you can choose to work an extra five years to help augment your cash flow. This outside-the-portfolio decision provides you with a higher probability of reaching your goal without necessarily having to take as much risk inside your portfolio.

Modulating risk in managed portfolios

It is important to remember that the portfolios that we manage are diversified from the get-go—whether that be across asset-class, sector or style. This is specifically for the purpose of managing risk. We often encourage clients to think of bonds as a kind of helmet that your stock allocation wears for protection.

But allocations are not static. Working with clients, and in particular in the multi-asset portfolios we manage, we deliberately and carefully adjust risk exposures across a market cycle. While keeping a focus on our “true north”—the appropriate asset allocation to meet a client’s goals—at the margin we will dial risk up, and down, seeking to smooth out market volatility as the cycle evolves.

It’s not always easy to think clearly about risk. But it's critically important, especially in a late-cycle environment, to consider whether de-risking is appropriate for you and your goals and, if so, how to manage it appropriately.