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The risk/risk trade-off

Our mission is to provide all of our clients with the highest investment returns at no-greater-than-average risk. The risk we have always focused on, in our pursuit of maximising investment returns for our clients, is the risk of monetary loss. In investments, we refer to this risk as 'absolute risk'. A secondary risk that is monitored is the risk of underperforming a benchmark – such as a published index or the average of our competitors – known as 'relative risk'.

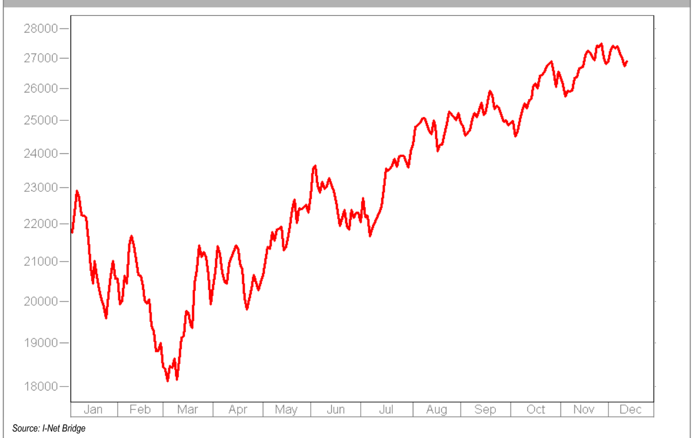
Absolute risk and relative risk are not mutually exclusive risk events – they are simply different ways of defining risk. Since our primary definition of risk is the probability and the extent of monetary loss, we try to evaluate the downside risk in any investment that we make on behalf of clients. We also seek to identify whether market conditions as a whole are creating an environment for higher-than-average risk of loss.

Of course, while we want to ensure we minimise the risk of loss, we also want to make sure we are not overly conservative to the point of missing out on potential return. Ultimately getting this trade-off right is key to successful investing. Howard Marks, Chairman of US-based investment manager Oaktree Capital, summarised this succinctly with the following statement: '... investors face two main risks: (1) the risk of losing money and (2) the risk of missing opportunity. Investors can eliminate one or the other, but not both ... they must consider how to balance the two.'

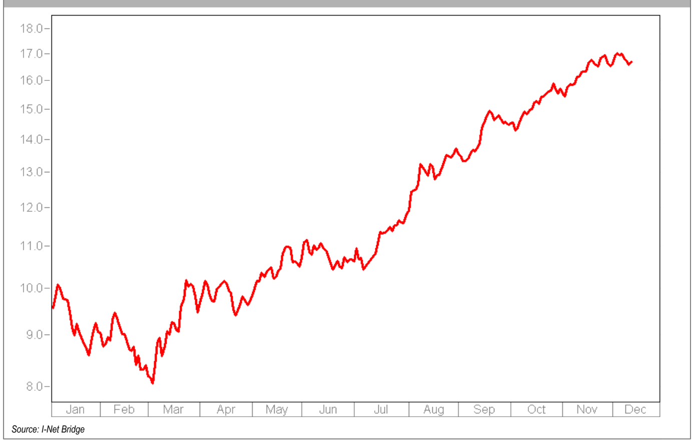
Where is the current tipping point in the risk/return trade-off?
Working out the balance between the risk of losing money and the risk of missing opportunity is highly dependent on the relationship between equity prices and their underlying fundamental valuations at any point in time. The pressing question clients ask us today is where we see the current tipping point in this 'risk/risk trade-off'.

To answer this question one needs to consider the context of current market pricing. For the year-to-date, the South African stock market (FTSE/JSE All Share Index, ALSI) is up 22% from 1 January 2009 and more than 40% since the March 2009 low (see **Graph 1**). The simultaneous re-rating of the ALSI is shown in **Graph 2**, from around 9x earnings at the start of the year to the current price to earnings ratio (P/E) of over 16x, well above the long-term average of 11.5x.

GRAPH 1 All Share Index



GRAPH 2 All Share Index P/E ratio



Our current assessment is that the risk of loss for the market as a whole is higher than average. This assessment is informed primarily by three key factors:

1. The current high level of the market and the pace at which the market has rallied this year (we believe this has occurred faster than underlying fundamentals would support)
2. The current valuation of the market as reflected by the P/E ratio and also the dividend yield and price-to-book ratio
3. The current level of earnings for the market as a whole, which we believe is still in above-normal territory

The risk of loss currently outweighs the risk of missing out
Our assessment that the risk of loss now outweighs the risk of missing out on further upside from current levels is apparent in our asset allocation portfolios, such as the Allan Gray Balanced Fund and the Allan Gray Stable Fund, where we have reduced equity exposure. This is especially evident in our Stable Fund, where investors are particularly concerned with the risk of loss over the medium to long term.

We believe that the safest, but also the most rewarding, strategy is to invest where the value is exceptional. While we have no special ability to predict the future, and are particularly cautious about making comments on short-term return expectations, we have relatively high conviction that the opportunities to invest in equities will be better in the future than we are identifying in the broader market at present.

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