OUR TWO CENTS

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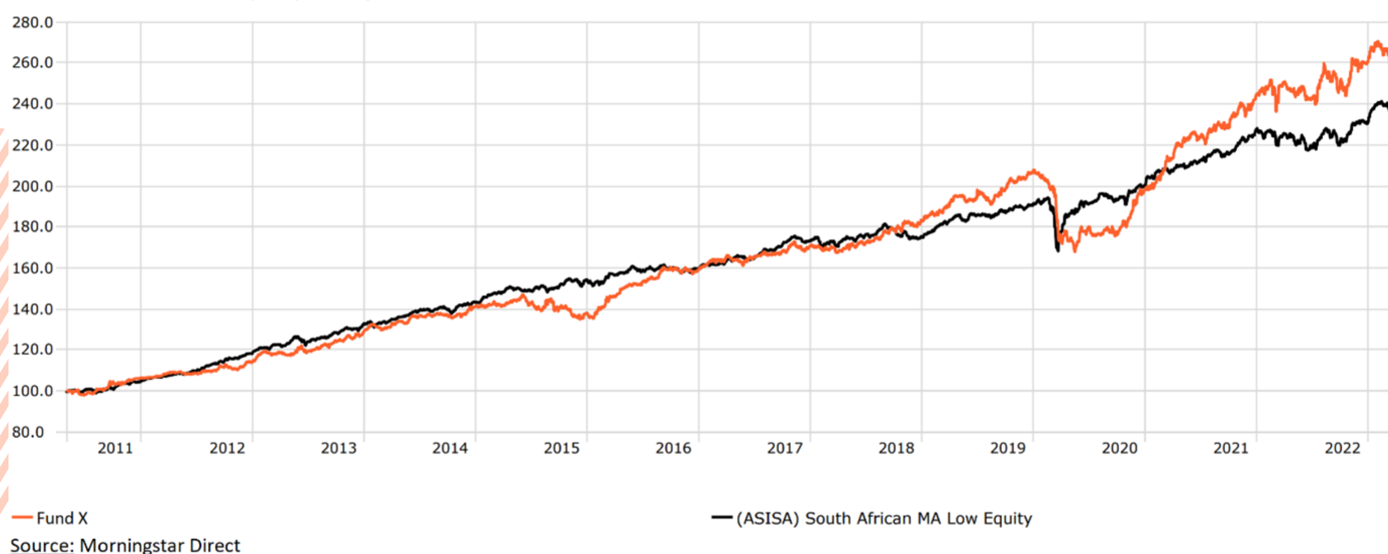
Returns vs Risk Adjusted Returns

by Michael Caroline

When choosing a suitable investment, it is not uncommon for individuals to focus largely on the past returns of the security with the assumption that the same return could be maintained going forward. However, when considering only returns, the analysis fails to place enough emphasis on the importance of personal risk tolerance when deciding between investment vehicles. In general, investors are only rewarded with higher returns when taking larger risks, even when these risks are not immediately evident. Taking on additional risk is not necessarily harmful to the investor, but it must be balanced with a longer-term investment strategy. Due to the higher volatility associated with more risky investments, the temptation may also be greater to sell out—often leading to a loss during a drawdown.

As an example of investors placing too little emphasis on risk analysis, some may incorrectly use only a fund's ASISA category to infer the level of risk associated with the portfolio. Consider the following chart illustrating the performance of Fund X and the ASISA South African Low Equity category average. Fund X clearly outperformed the category over the full period; however, the investor would have to stomach deeper drawdowns when choosing this fund. Fund X had a maximum drawdown of 19.26%, much deeper than the category average of 13.99%. An investor who had carefully considered the risk profile of this fund and held through the drawdown would have been rewarded with an outperformance relative to the benchmark.

Fund X Investment Growth



Source: Morningstar Direct

Fund X would have been a great investment if the investor bought into the fund in early 2020, however, the investor's satisfaction with the investment may have been vastly different had the investment been made in 2019 and could lead to the individual disinvesting. If the investor sold out during the drawdown, they would have realised a loss of around 18%, and, although an investor may think that they would not do so, it is important to remember that a market drawdown is only possible when many investors sell out around the same time. Their uncertainty regarding the path of the investment, particularly during a drawdown may result in the investor selling out at a loss. In short, the overall return of the fund is good, but it is important to think of the risk taken to achieve those returns and whether one would be able to ride it out when the end point is uncertain.

It is clear that, although the fund belongs to the ASISA South African Multi Asset Low Equity category, it took more risk than the category average. As a result, it may not be suitable for many individuals considering funds in the category—some may not have the willingness while others may not have the ability to take such risks. Investors should ensure that their choice of investment is appropriate for their risk tolerance and be willing to hold their investment through tough periods to realise the benefit of their investment.

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