

Insights

Managing Portfolio Risk

A common pitfall for many investors is not having an appropriate amount of risk exposure and/or mitigation in their investment portfolios. As a result, investors may miss out on the benefits of earning potentially higher and more consistent returns. For clients comfortable with some risk, a better approach is to consider the risk factor but take a more active approach to controlling and managing risk.

Yet maintaining the right amount of risk requires rigorous effort because getting the timing right on when to increase or reduce risk exposure can be both challenging and time consuming.

The Risk and Time Factor

Investors who are focused on earning high returns in bull markets often ignore the risk factor by inadvertently embedding excessive risk in their portfolios. Conversely, when markets are volatile, many investors reduce their risk excessively, resulting in missed opportunities. These behaviours are generally driven by emotions, such as fear and regret, which seem to operate in tandem.

In a market rally, investors may fear that if they sell too soon they may miss further gains in the long term and, as a result, tend to hold onto their positions and try to continue to ride the wave rather than embed protection for the investment. This can be a risky proposition if the market suddenly drops.

When markets are volatile, investors may fear that they could lose their principal if the market drops further. Instead of selectively investing in the right assets, they tend to stick with highly safe and liquid instruments, like cash, unnecessarily and for too long. This could mean the loss of potential earnings by sitting on the sidelines.

Meanwhile, other investors cannot afford the time to oversee the ideal level of risk exposure in their portfolios. These investors can become immobilised because they don't have time to follow the market closely and they don't know the "right" moment to make investment decisions. In practice, very few investors have the time to closely track their portfolios, including the management of risk.

An Alternative to Managing Portfolio Risk

One alternative that can help manage portfolio risk that is suitable for many investors is the principal-protected investment product. This investment — sometimes known as a structured product or structured note — can help protect gains in a rising market while also providing the potential for further gains. When markets are more volatile, these investments, which protect the principal, can help investors overcome their fears of possible further loss, including their initial investment, since they guarantee the return of the investor's principal if held to maturity.

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Principal-protected products can achieve these objectives by using risk-management techniques, including the use of derivatives. Derivatives are financial contracts, typically with a fixed investment period (or "tenor"), traded on exchanges or between financial institutions. These contracts are often used as risk mitigation and management tools by professional risk managers and investment managers, in addition to being used in principal-protected products.

The end result is a product that automatically and dynamically adjusts the exposure to the underlying assets, with the goal of maintaining the right exposure without eroding investors' principal at maturity of the product. This allows investors in these products to benefit from professional risk-management expertise.

To effectively manage risk, a structured product should have:

- An underlying investment that has the potential for attractive returns. The underlying investment may include equities, but could also include alternative investments, such as hedge funds or fund of hedge funds, which have lower correlation to traditional asset classes — to help reduce investor risk without giving up potential gains
- Built-in principal protection
- Built-in dynamic risk-management features that limit investors' time involvement

Standard Chartered Bank offers several kinds of structured products or principal-protected products that have the potential to help manage portfolio risk. For more information on these products or to learn more about managing portfolio risk, contact your Private Banker.