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OPINION

Markets Insight

Risk management is the alpha for a time of uncertainty

After two decades of easy money, investors will have to manage portfolios with almost constant market challenges ahead

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Well, it was fun while it lasted. Two decades of easy money with low to zero interests, further juiced by successive rounds of ever larger stimulus spending, turned prudent investment principle on its head.

Scores of novice investors flocked into the markets with the belief that buying every dip was a masterclass strategy to guarantee profit. That's understandable; when there is only upside, it's easy to be fooled into thinking flash can replace knowledge and that gimmicks can substitute for discipline.

But the events of 2022 poured cold water on that exuberance. During the past 12 months, we experienced the biggest interest rate shocks in recent memory. High inflation hurt equities and debt markets, negatively impacting businesses and consumers worldwide. At the same time, China's Covid-19 lockdowns stifled demand and choked production and Russia's war against Ukraine sent energy and food prices skyrocketing.

As the quantitative easing support programmes for markets from central banks give way to quantitative tightening, myriad emerging headwinds have increased uncertainty on a global level.

Risk management is the alpha — the returns above market benchmarks derived from investing skill or choice. In this environment, what were once considered to be 100-year events have become everyday occurrences. As a result, risk management has been elevated from a supporting player to the star attraction.

With fears of job cuts and possible (or possibly not) recession ever present, higher prices and consumer caution the new norms, relying on the "same-old, same-old" investment strategies is not only not an option, but the riskiest strategy of all. Effective risk management is what can provide above-average returns to active, passive and everything-in-between investors. That's why we are seeing a flight to futures, as some of today's most important trades are to manage risk.

No guarantees, but hedging can provide certainty. Considering what all investors are up against, there are no havens. Despite economic risks, the US central bank shows no indication of changing course until inflation falls closer to its 2 per cent target. Around the world, uneven responses by central banks to tamp down inflation have added to uncertainty and fluctuating exchange rates, all while the market adjusts to a rapid shift from the Libor benchmark for borrowing to Sofr, or the Secured Overnight Financing Rate.

Commodities are not immune either. US food costs rose last year to their highest levels since 1979. Persistent concerns of global economic weakness continue to have an impact on global energy demand, creating price volatility. That's also true in metals markets, where geopolitical events could compound the imbalance in supply and demand for minerals vital to an energy transition.

We can never lose sight of the role innovation plays in shaping financial markets and, in turn, growing business and economies. This is critical in enabling new businesses to sell debt and raise capital to fund expansion opportunities, bring ideas to market and develop new products, all of which create jobs and facilitate the evolution of industry.

But not every idea is a good one — a sobering fact that was less obvious in the recent environment where the elevator only went up and everyone could seemingly get to the penthouse. Innovation needs a use case that demonstrates purpose, solves a problem or creates a benefit. Without that, it is merely noise.

Smart regulation is fundamental. Customer protections must always take centre stage. Markets like clarity, and they work best when clear rules and common standards are in place, transparent and understood by all. Likewise, counterparties and market integrity matter a lot. During the last couple of years as trading in meme stocks took off and the fear of missing out replaced due diligence and best practices, the extraordinary collapse of new assets such as cryptocurrency once again reinforced the reality we already knew: strong, effective regulation is non-negotiable.

Looking ahead, we can expect a whirlwind of geopolitical and economic hurdles to continue. For markets, that means it will be even more difficult to determine the highs or the lows. For investors it will mean managing portfolios with the best information out there, knowing it may all change. With near constant market challenges ahead, effective risk management will be crucial. To navigate this new age of uncertainty, expecting — and planning for — the unexpected could be the differentiator that separates disciplined investment strategies from distractions.

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