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Balancing Risk and Reward: A Roadmap for Uncertain Times

François Desjardins, Editor
In collaboration with Antonio Cabeda, Director, Investment Solutions, K. David Johnson, Vice-President and Co-Head, Client Partnerships and John Stilo, Senior Portfolio Manager, Insurance and Investment Solutions

Following equity and fixed income markets' rough start to 2022, many investors have growing concerns about where future returns will come from. Matters that may be on their minds include strong inflation levels, strong interest rate increases and geopolitical uncertainty following the Russian invasion of Ukraine. We think now is the perfect time to revisit the basics of how Addenda Capital assesses risk with clients.

Risk is the possibility that an investment's outcome might be different than what was anticipated. As stock markets face slowing economic growth and as rising rates impact bond markets, investors and their asset managers more than ever need a common, clear assessment of risk tolerance.

Addenda's approach to portfolio construction starts with a simple question: how much risk is an investor comfortable with? Given a certain set of objectives and constraints, what can a client reasonably tolerate before worries start setting in? For some, time devoted to this phase of the risk assessment exercise will seem longer than initially thought. This will only result in a higher quality portfolio. We believe that a detailed approach to risk leads to more efficient decision-making in portfolio construction. Such a strategy leads to more suitable representations of what is required in terms of allocation across risk levels and asset classes.

Any analysis of an asset owner's needs should cover critical aspects such as their financial position, liquidity needs, time horizon, fiscal status, underlying business, cash inflows and goals. Gathering this information to produce a clear picture of a client's risk appetite requires specific expertise.

While investors are obviously best positioned to provide details on the risks they face, investment firms such as Addenda Capital can help underline points that should be worth considering:

- Is the greatest risk income volatility? To what extent could the prospect of irregular income, stemming from a market downturn or a disturbance in a specific asset class, affect financial goals? If so, what would the most extreme situation look like and how long would it take for things to get back to normal?

- What magnitude of loss could the portfolio withstand in a market downturn without jeopardizing the financial objectives of the asset owner?

- How strong is the need for quick access to invested assets? Answers to this question might lead to the choice of certain holdings which can be less liquid.

- Do financial needs of the investor feature regular or irregular outflows? What is the size and timing of those outflows, and are the incoming contributions larger?

Once parties agree that no stone is left unturned, the investment manager and client can start developing parameters for determining risk tolerance, which then leads to using a risk/reward optimization approach to construct an appropriate portfolio.

Risks to Monitor

Aside from the usual set of risks to monitor, such as liquidity risk, credit risk and equity risk, Addenda is obviously keeping an eye on the potential impacts of the tragic events unfolding in Ukraine. We are also working on climate risk which involves building in-house scenario analysis addressing the possibility of outcomes that fall between a 1.5-degree scenario sought in the Paris Agreement and higher-warming "current policy" scenarios.

Here are specific situations Addenda has been monitoring:

- Details surrounding how central banks reduce the size of their bond purchase programs, as well as the pace/amount of policy tightening that may contribute to market volatility;
- Facing a path of inflation proving more persistent, central banks could move aggressively to combat price increases, negatively impacting economic momentum in the process;
- Pandemic-related lockdowns should diminish, although uncertainties will continue throughout 2022.

In conclusion, a wide-ranging assessment of risk tolerance is an essential part of our investment process, and our commitment to understanding the needs and expectations of our clients is vital to the design of investment strategies and solutions seeking to meet their financial objectives. To learn more, please contact our Business Development and Client Partnerships team: https://addendacapital.com/contact-us.