How to De-risk your Portfolio

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As volatility in markets jolt and intraday price swings become more pronounced, many investors are looking at ways to reduce risk in their portfolios. Most investors make the mistake of interpreting 'de-risking' as just locking-in gains and cashing out from the market.

But de-risking entails more than just cutting one's exposure and shifting all their asset allocation to cash. Here are 4 ways investors can lower risk in their portfolios without derailing their long-term plan whilst also staying invested.

Hold Some Cash

Cash may be king, but not always and certainly not in excessive amounts in a portfolio. Most investors would automatically flock to cash when faced with higher market volatility or when signs of headwinds appear.

As a safe haven asset class, cash is arguably the safest in its category. But it also offers no real returns and its nominal value can be diluted by inflation. Keeping some cash can ensure some form of capital preservation, but the investor also sacrifices yield and could potentially miss out on higher returns when markets rebound.

Holding large amounts of cash also introduces another dilemma when investors plan their eventual entry back into the market. This involves a significant degree of market timing which is near impossible to achieve.

History has shown that investors often never get it right when they attempt to buy at the bottom or sell at the high. In fact it's usually the other way around because of herding mentality in markets and the presence of algo-traders.

The ideal amount of cash to hold in a portfolio differs from one investor to another. But it typically ranges between 5%-10% depending on the investor's time horizon and risk profile.

Shift to Quality

Investors who have an aggressive portfolio with large weights in growth and small-cap funds, may want to think about taking a closer look at their overall exposure and see how they can put a more defensive slant. Chances are in an upmarket, the investor would have allowed their winners to run in a portfolio resulting in large concentration in growth names.

The investor could look into locking-in some gains from the more aggressive portion in the portfolio and reinvesting them back into funds with a more balanced and conservative bias. These could include a dividend, REIT or mixed asset fund that tends to perform better in more volatile market conditions with its income attributes and dividend-yielding equities.

At the margins of the portfolio, investors may also consider tweaking exposure to focus on more quality names and defensive sectors that are less prone to cyclical changes in the economy. Companies with strong balance sheets and structural growth counters in healthcare and consumption have the ability to perform better in periods of market stress especially in a late cycle.

Stability in Fixed Income

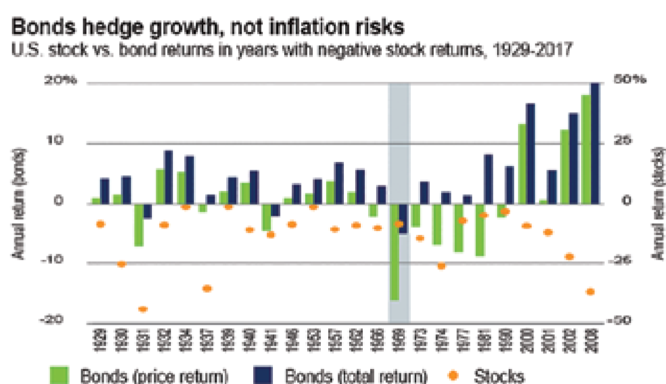
Another efficient way of reducing risk in a portfolio is by adding exposure in fixed income. Acting as a ballast in a portfolio, fixed income or bonds plays a valuable role in providing a steady income stream as well as a source of capital protection.

Drawdowns in bond prices are also less severe compared to equities during periods of market turbulence because of its low correlation with other asset classes.

Throughout history, there were a total of 24 years when US markets posted negative equity returns since 1929 (See Table 1 below). In all these years, bonds recorded positive returns except for 3 years (i.e. 1931, 1941, 1969).

This clearly illustrates the role of fixed income as a diversifier of equity risk to help cushion losses in a market downturn. Historically, it also shows that markets have never experienced 2 years of negative returns in bonds before.

Table 1: US stock vs. Bond returns in years with negative stock returns, 1929-2017



Investors can consider short duration bond funds or target maturity products that provide more clarity due to its fixed tenure as well as predictability of returns in a portfolio

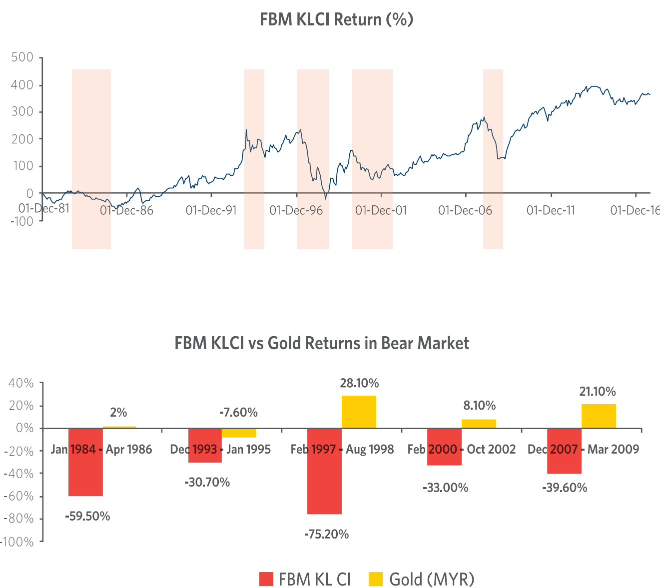
Gold for Good Measure

Gold prices shot to new highs this year breaking above the S$1,400 level for the first time since 2013 amidst recessionary risks. Other factors driving this rally were expectations of lower interest rates and geopolitical risks, with further support coming from strong central bank buying.

As a safe haven asset, gold has held a traditional role as a store of value for investors during heightened periods of market volatility and economic stress. Demonstrating resilience in times of market uncertainty, gold has the potential to lower overall portfolio volatility and increase risk-adjusted returns as a hedging instrument.

Whilst, gold is not known for its ability to generate high returns, its role as a natural hedge can grant downside protection and prevent losses from being amplified in a portfolio. Table 2 shows the performance of the benchmark KLCI compared to gold in a bear market which displays how having some gold exposure can shield losses in a down market.

Table 2: FBMKLCI Vs Gold Returns



De-Risk with Discipline

De-risking is a process that should not be rushed and done as calm and dispassionately as possible. Investors should definitely refrain from switching between different funds or asset classes in lump sums. Instead, spread the risk over a reasonable time horizon by staggering the more aggressive portion of the portfolio into more defensive asset classes like bonds perhaps on a monthly or quarterly basis.

More importantly, investors should not de-risk their portfolios in a knee-jerk manner by responding to negative market headlines or intraday volatility.

Also, don't try to time the market when de-risking. Investors should not be swayed by market swings or things they read from alarmist news headlines.

The market does not always move in a steady progression. Some of the best days in markets are charted in short sporadic bursts which are hard to capture. This emphasises yet again the importance of staying invested and avoiding the futility of trying to time the market.

Instead, adhere to the wisdom of asset allocation and avoid drastic shifts in a portfolio from one asset class to another.

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