Safety is Inherent in Your Business, As Risk Management is in Mine

By Charlene Birdsall, CPA, CMA, CIM, CFP, National Bank Financial

Risk management can come in many forms, from wearing a hard hat and steel toed boots to wearing a seat belt and being law abiding, which is meant to protect us all. The COVID-19 pandemic has been an uncomfortable reminder that we are all vulnerable to risks that can have unprecedented effects. These effects are not only health wise, but with our day to day activities, our economy, and even changes to what is working in the stock market. Life as we knew it is different now.

As investors, we could try and avoid these terrible events, but for most of us, overly defensive tactics such as not participating in the markets does not help in achieving our goals over the longer term.

As the saying goes, perhaps, "the correct lesson to learn from surprises is that the world is surprising." Equity markets inherently come with risks. In order to reap the potential returns offered by the markets, investors must be willing to accept that surprises can happen from time to time.

While risks in investing can never be eliminated, they can be managed. During buoyant market periods, the need for risk management may not be overly apparent. It can be easy to get caught up in the momentum and continuous market advances. Yet, risk management does not focus on achieving the highest possible rates of return – it is about preserving your hard-earned money and support you in achieving the returns needed to accomplish your goals. Often, it's only when prices head downwards that the value of risk management becomes more obvious.

This means following various guidelines that have been established to control risk. We do this in various ways, such as maintaining a strategic asset allocation. For example, a balanced portfolio holds approximately 40 per cent invested in fixed income securities for stability like bonds, debentures, bond mutual funds, preferred shares, and fixed income Exchange Traded Funds (ETF), and 60 per cent in equities for growth. We also rebalance portfolios back to target allocations (i.e. 40 per cent fixed income/60 per cent equities) when the portfolio asset allocation drifts too far. This would occur when the equities have increased in price. We would then take profits and reinvest appropriately for rebalancing the portfolio.

Another way to mitigate risk is to limit the size of any security by holding approximately three to five per cent of your portfolio in any one common stock. This way, if something goes wrong with the company, it does not affect the total portfolio too much. Another risk strategy is to diversify exposure across various sectors, like financials, technology, consumer discretionary consumer, consumer staples, real estate, telecommunication, utilities, industrials, materials, and energy.

Over the years, some sectors are highflyers (like technology in 2020), and some sectors drop immensely (like energy or real estate in 2020). A portfolio should also be diversified geographically, as the Canadian market is only three per cent of the world market. To mitigate home bias risk, a portfolio should hold equities globally and internationally. With all this in mind, the most important part is paying particular attention to an investor's personal risk tolerance levels.

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As hard and fast as equity markets fell in late February, the rebound in April was equally stunning. As award-winning finance columnist Morgan Housel has said, "You will likely be more fearful when your investments are crashing and more greedy when they're surging than you anticipate. And most of us won't believe it until it happens." Sometimes emotions can pose risks to short-term decision-making that can affect longer-term well-being. Advisors help to take the emotion out of investing.

While everyone has an idea about how things will continue to unfold, nobody can be certain about the near-term path forward, especially in the aftermath of the United States election. Risk management practices are intended to help protect investors from the potential changes. During these challenging times, investing requires patience to understand that the markets will inevitably encounter surprises along the way, as well as the resolve to remember that portfolio guidelines have been put in place to support your journey to investment success. We, as advisors, can ensure your portfolio has the protection for downside risk with a systematic approach.

Stay safe.

Charlene Birdsall, CPA, CMA, CIM, CFP, is an Investment Advisor and Portfolio Manager for National Bank Financial. One of her main roles is to act as a risk manager, and she puts great care into preserving capital and growing it over the longer-term. You can reach Charlene at 204-925-2252, charlene.birdsall@nbc.ca.