GFG CAPITAL
A FAMILY OFFICE

VIEWS FROM THE BRICK

KNOW YOURSELF

We want to focus on you for a second. We often times come to this blog to bring our views and interpretations of what is impacting the markets and how we go about our portfolio construction process. But this post is going to be all about you. Before we ever get to the conversation of what an investor's asset allocation should look like, there is a world of information about the beneficiary we need to unearth. In order for us to know how to move forward with selecting the investments there's one topic everyone involved needs to be on the same page with: risk. What is it? What does it mean to me? Why does it matter? How much can I take on? How much should I take on?

RISK TOLERANCE + RISK CAPACITY = RISK PROFILE

Regardless of what you've been sold in the past, risk isn't confined strictly to the standard deviation of returns on an investment. That is a microcosm of the risk assumed by an investor. It all starts with defining a risk profile. This is a combination of two things: your risk tolerance and your risk capacity.

Both are different, but the combination of the two are what creates the risk profile you carry as an investor. Your risk capacity is how much risk your portfolio can assume and weather (potential downfall of principal) without you having to sacrifice your lifestyle. This is basically your financial ability to take on risks. Your risk tolerance is what you're able to take on psychologically. Maybe not so much an actual impact to dollars in your pocket, but your ability to withstand potential whipsaw action over a period of the investment's life. Chances are, if there is an allocation within your portfolio and it is relatively small (i.e. 2%) and month to month it appears to be the one thing that dominants your headspace (arguably your most valuable real estate), then perhaps you've gotten involved with something that's a bit too far out of your comfort zone.

HOW DO YOU MEASURE YOUR RISK PROFILE?

Some of the biggest questions that need answering include time horizon, liquidity needs, investment objectives and any unique preferences for one's portfolio. Certainly all of these factors come into play when coming up with your risk profile, but what we think often times influences investors' answers to these questions is historical investment experiences. The best way to understand what you might be able to tolerate psychologically moving forward is analyzing what you've done in the past and how you reacted to events with those investments that were unexpected. The one constant over time is how we as people react to things that are unexpected. This along with your liquidity needs, time horizon and personal objectives will likely paint you a good self-portrait.

WHY ARE WE STARTING WITH RISK? WHY CAN'T WE JUST AVOID IT?

Outside of the risk free rate, which is really something we've agreed on as investors and is certainly subject to change (see US credit downgrade in 2011), risk is in everything and is everywhere. Like the cloud, it follows us everywhere. Arguably the most important step to the investment process is an investor's ability to accept and digest this. Achieving a return, no matter how little or large can't be done without taking on some amount of risk. One way to think about this is return is the end product we're buying as investors and units of risk is the token we are using in exchange. Certain levels of return will require certain amounts of tokens. Inherently: more risk = more return potential. The degree of risk aversion is what will change from investor to investor.

The risk of avoiding risk, we think, likely comes from investors holding onto past investment experiences. It is important to acknowledge that the world is changing every second, and the investment universe embodies this maybe better than anything else. Investors continuously assume the return profile they were achieving in different periods is what they can grow to expect moving forward as well. The flaw in this thought process is that as the environment has changed, expectations change with it for better or for worse. So investments that used to achieve a return of X may not be able to reach that mark moving forward. And if investors aren't willing to alter their risk profile, then they likely will not be able to generate returns they were accustomed to. A way to avoid this trapped perception is employ a true active management approach of continuously being in touch with your portfolio and the market you're invested in.

TECHNICAL RISKS

Once we've outlined the biggest risk to your portfolio (*you!*), we can begin the matrimony process of pairing the investor with the technical risks they'll need to assume in order to reach their goals. This is where pieces of the puzzle like inflation, market risk, interest rate risk and duration (to name a few) come into play. When building a diversified, and in theory balanced, portfolio, these are all risks you should be tracking into consideration on each allocation on an individual level. Once you've put together what you think is a sound thesis and understanding of where a market is headed, the portfolio should behave collectively in a way that you're both protected and well positioned to capitalize on any of these givens risks over the time horizon you've set for yourself.

YOU'RE NOT DONE

As the beneficiary of the portfolio, your job doesn't end once you've laid everything out there on the table for assessment. Risks, like the markets, are dynamic in nature and are perpetually changing. We meant it when we said you're the biggest risk to your portfolio. You don't just pose a risk to yourself when generating an investment policy, but every day after that policy has been agreed upon. Human nature is often times working against us when trying to invest, particularly for the long term. Having the tenacity to recall why you set out on this investment objective when you're in the midst of a market correction or an unknown unknown has presented itself is integral to investment success. At the end of the day, nobody is going to be able to control what markets do (despite what central bank conspiracies might say). What we can control is ourselves and how we respond to the unexpected. Know yourself, and you've won 90% of the battle.