



## Navigating Risk Discussions with Clients

Effective communication about risk is essential for investment advisors when engaging with clients. By adopting a holistic approach and employing plain language explanations, advisors can help clients gain a deeper understanding of risk and make more informed investment decisions. This paper aims to equip investment advisors with the tools and knowledge necessary to discuss risk effectively, resulting in stronger client-advisor relationships.

### **Downside Capture Ratio:**

The downside capture ratio is a metric used to assess how well an investment performs during periods of market decline or downturns compared to a benchmark index. It helps investors understand the extent to which an investment may be affected by negative market movements. A lower downside capture ratio indicates that the investment tends to lose less value or is less volatile than the benchmark during market downturns, which can be seen as a positive attribute.

For example, let's say you have an investment portfolio and you want to evaluate its downside capture ratio against a relevant benchmark, such as the S&P 500 index. If the downside capture ratio of your portfolio is 80%, it means that during periods when the S&P 500 experienced a decline, your portfolio, on average, captured only 80% of that downside movement. In other words, it indicates that your portfolio has a lower sensitivity to negative market movements compared to the benchmark. A lower downside capture ratio is considered favorable, as it suggests that the investment has the potential to provide more stable returns and may offer some level of downside protection.

Understanding the downside capture ratio can be valuable for investors who prioritize risk management and seek investments that demonstrate resilience during market downturns. It helps investors evaluate the consistency and stability of an investment's performance, particularly in adverse market conditions. By considering this metric alongside other risk measures, advisors can gain insights into an investment's risk profile and make more informed decisions.

### **Down-Market Beta:**

Down-market beta is a term used to measure how an investment performs relative to the broader market during periods of market decline. It provides valuable insights into how an asset or portfolio may react during bearish market conditions. Think of it as a gauge of an investment's sensitivity to downward movements in the market. It allows investors to assess the potential downside risk associated with a particular asset or portfolio, helping them make informed decisions and manage their investment strategies more effectively.

When considering down-market beta, it's important to remember that not all investments respond to market downturns in the same way. Some investments may be more resilient and show less decline during bearish phases, while others may be more susceptible to sharp drops. By analyzing down-market beta, investors can evaluate how an asset or portfolio has historically performed during market downturns and gain insights into its defensive qualities. This information can be particularly valuable for those who prioritize risk management and seek to balance their portfolios with assets that have lower down-market beta, aiming for more stability during challenging market conditions.

Example: If a client's investment has a down-market beta of 1.2, it means that during market downturns, the investment's price is expected to move 20% more ( $1.2 - 1 = 0.2$  or 20%) than the overall market.

### **Down-Market Correlation:**

Down-market correlation refers to the relationship between different investments during periods of market decline. It helps us understand how various assets tend to move in relation to one another when the overall market is experiencing a downturn. This correlation can have a significant impact on portfolio diversification and risk management strategies.

For instance, let's consider a down-market scenario where the stock market is experiencing a significant decline. During such times, traditionally riskier assets like stocks may exhibit a negative correlation with safer assets such as government bonds or gold. This means that when stock prices decline, the value of government bonds or gold tends to rise or remain stable. This negative correlation can provide a cushion to investors as their diversified portfolio is less affected by the decline in the stock market. By understanding down-market correlation, advisors may potentially mitigate losses during market downturns.

In addition to the stock-bond example, down-market correlation can also apply to different sectors within the stock market. For instance, during a recession, certain sectors such as consumer staples or healthcare might demonstrate a lower correlation with the broader market. This means that these sectors could potentially outperform or experience smaller declines compared to other sectors like technology or financials. By identifying sectors with lower correlations to the overall market, advisors can consider adding them to their portfolio to potentially reduce overall risk and increase the likelihood of better performance during down-market periods.

### **Standard Deviation:**

Standard deviation is a statistical measure used to assess the volatility or risk associated with an investment. Think of it as a way to gauge how much an investment's returns tend to deviate from its average return over a specific period. It helps advisors understand the potential ups and downs they may encounter when investing in a particular asset or portfolio. A higher standard deviation implies a greater degree of fluctuation, indicating a riskier investment, while a lower standard deviation suggests more stability and lower risk.

To better understand investment standard deviation, let's consider an example. Imagine you are comparing two investment options: Option A and Option B. Option A has an average annual return of 10% with a standard deviation of 5%, while Option B has the same average return of 10% but a higher standard deviation of 15%. This means that Option A's returns tend to deviate from its average by around 5%, while Option B's returns have a wider range, fluctuating by approximately 15% around its average. In this case, Option B carries a higher level of volatility and risk compared to Option A. However, it's important to note that higher risk doesn't always mean poor performance, as some investors may be willing to accept greater volatility in the pursuit of potentially higher returns.

**Kurtosis:**

Kurtosis helps us understand the shape and distribution of investment returns. It provides insights into the likelihood of extreme returns, both positive and negative, relative to the average return. Think of it as a way to gauge the "peakedness" or "flatness" of an investment's return distribution. Kurtosis allows us to assess whether an investment has a higher probability of experiencing rare, extreme events or if it tends to have returns that cluster more closely around the average. By considering kurtosis, investors and advisors can gain a better understanding of the potential risks and rewards associated with a particular investment.

Let's consider a relatable example to illustrate investment kurtosis. Imagine you have two investment options: Option A and Option B. Option A represents a highly volatile investment, such as a cryptocurrency, while Option B represents a stable investment, such as a bond. Now, when we analyze the kurtosis of these options, we find that Option A has a high kurtosis value, indicating a peaked distribution. This suggests that Option A is more likely to experience extreme returns, both positive and negative, compared to Option B. On the other hand, Option B has a lower kurtosis value, indicating a flatter distribution, which implies that it has a lower likelihood of extreme returns and tends to exhibit more moderate and stable performance.

**Low End of a CAGR Ranges:**

When assessing investment risk, it's important to consider the low end of the Compound Annual Growth Rate (CAGR) range. The CAGR range provides insights into the potential variability in investment returns over time. At the low end of the range, we get a sense of the worst-case scenario or the periods when the investment may underperform. By examining this range, we can gain a clearer understanding of the potential risks involved and make more informed investment decisions.

For example, let's consider an investment in a diversified stock portfolio. Over a 10-year period, the CAGR range might be estimated at -4% to 10%. While the average CAGR might be around 5%, the low end of the range (-4%) reveals the potential downside and highlights the possibility of periods when the investment may not generate positive returns. This understanding allows investors to prepare for potential downturns and helps them set realistic expectations about their returns.

It's worth noting that the CAGR range tends to narrow as the investment timeframe lengthens. This exemplifies why investing is a long-term endeavor. With a longer time horizon, the impact of short-term market fluctuations diminishes, and investors have a better chance of achieving returns that are close to or even above the average.

**Conclusion:**

iQUANT believes taking a holistic approach to discussing risk with clients is crucial for investment advisors. By employing plain language explanations and relatable examples, advisors can have meaningful discussions surrounding downside capture ratio, down-market beta, down-market correlation, standard deviation, kurtosis, skew, and the low end of a CAGR range.

This comprehensive understanding of risk metrics equips clients to make informed investment decisions, fostering trust and a stronger client-advisor relationship in addition to protecting the investment professional.