For professional advisers only

MANAGING RISK IN THE GRIPs

There are lots of ways to measure risk. The most common is volatility however for the Governed Retirement Income Portfolios (GRIPs) we use a measure called downside risk. But what do we mean by downside risk and why do we focus on it?.

WHAT IS DOWNSIDE RISK?

Downside risk is a risk measure that focuses on the "worst case" scenario. Most investors are more concerned with how much they could lose, rather than how much they could gain, and downside risk can show us how wrong it goes when it does go wrong. In other words it's a bit more doom and gloom because it focuses on the downs. For example, we can use downside risk to say that for the majority of the time, the investment is unlikely to fall more than "x%". The flip side is that there is a very small chance that it could fall by more than x%.

WHY NOT USE VOLATILITY?

Volatility is a more commonly known risk measure but it measures both the ups and the downs. This is fine for accumulation strategies as it allows us to get an idea of the possible fund values that we could end up with on a particular date in the future. But it's not very useful when we're thinking about drawdown.

When taking income customers are unlikely to be concerned with increasing income levels, however a reduction in their income is likely to have a significant impact on their lifestyle. The impact of reductions in income mean we are more focused on the bad scenarios for drawdown than the good scenarios.

For this purpose, downside risk is much more useful for the GRIPs.

THE TWO RISK MEASURES

We have two downside risk targets for the GRIPs; a short-term and a long-term.

THE LONG-TERM MEASURE

This measure looks at the total income that can be generated over a customer's lifetime relative to a portfolio of 10 year index-linked bonds.

Long-term measure					
	GRIP 1	GRIP 2	GRIP 3	GRIP 4	GRIP 5
Downside risk target in lifetime income (%)*	8.5%	14.0%	19.0%	25.0%	31.0%

*+/- 10%

This shows there is a very small chance (5% to be exact) that GRIP 3 will produce an income of at least 19% less than a portfolio of index-linked bonds, over the customer's lifetime. Alternatively, for the majority of time it will perform better than this.

...AND INTRODUCING THE NEW SHORT-TERM MEASURE

The long-term measure is robust in itself but it doesn't consider the fall in income over any one year. That's why we created a new measure which simply focuses on the potential falls in income on a year on year basis. These numbers look like this:

(New) Short-term measure					
	GRIP 1	GRIP 2	GRIP 3	GRIP 4	GRIP 5
Downside risk target over one year (%)*	6.0%	9.0%	12.0%	16.0%	20.0%

*+/-10%

This shows that there's a small chance (again 5%) that GRIP 3 will lose 12%, or worse, income over any one year. Alternatively, it will perform better than this over the majority of times.

Investments

By fusing together two central risk measures over two different time periods, we're making the risk management process of the GRIPs more robust and more customer-focused. Of course it's important to remember that downside risk doesn't tell us anything about the upside and what it might look like, but that's a story for another day.

However, remember that prices can fall as well as rise meaning you may not get back the value of your original investment.

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