

Now it is easier to see what risk is

Brexit delivered a shock to the political and financial world in the UK. No one expected it, although the vagueness of opinion polls should have been a warning. The immediate aftermath was a sharp fall in the value of sterling and UK equities followed by a recovery of UK equities in sterling terms although not when measured in other leading currencies.

With hindsight it looks as if some large traders were positioned the wrong way ahead of the vote and had to unwind positions in short order. Good for brokers but unsettling for investors. Nevertheless, it now appears that a calm has been restored to UK, and rather oddly, overseas equities as well. The fact that the impact of the UK poll had such large repercussions tells us that markets were poised for a change, but were not quite sure which way to go.

In the UK the most obvious development was a dramatic increase in the incipient divergence between the large companies and the smaller ones. Over the last three months the FTSE 100 has gained 8.6% while the FTSE 250 is up only 3.4% and over six months the differences are even larger at 13% and 6.3% respectively.

As with any such development there are a number of reasons for this. One is that the larger companies are international and have very little exposure, in some cases none, to the UK economy. Another factor is that a weaker sterling increases the value of profits and cash repatriated from other currencies. In addition larger companies are viewed as less risky than their smaller brethren and in part that is related to perhaps the major reason for the divergence which is the different levels of liquidity.

This issue is most obvious in the property sector and is well illustrated by the 9% drop in the FTA REITS Index over the last 3 months and that is a continuation of the 22% fall over the last year. However, the fact that it is still up 56% over 5 years is a measure of how far it has travelled. Looking back it is obvious that the sector had become overpriced and was due for a correction and that logic also applies more widely to the mid and small cap sectors.

The risk is twofold. One is investing in assets that are expensive and the other is investing in assets that are illiquid. Although they are often related they are quite different risks. Illiquidity means that an asset cannot be traded quickly and/or in any meaningful size. This can mean that when a lot of money is seeking to invest in the asset the illiquidity pushes prices up until it finds a willing seller. That can result in valuations becoming stretched unless earnings rise at the same rate. If they don't the asset then looks more expensive and vulnerable to the process being reversed as prices are knocked down until a price is discovered that a willing and able buyer is prepared to trade at.

This issue is less of a problem for large liquid shares, typically known as "Blue-Chips" where trading is always possible and in large size. Historically, this attractive feature meant that they often traded at a premium to smaller companies, and is arguably one reason for the small cap effect in which smaller companies have outperformed larger ones. In reality it may just be related to the value factor.

While long-term investors will not be interested in the short-term variations in price caused by liquidity issues it will impact the volatility of their portfolios and that does have a bearing on long-term returns. Mathematically lower volatility portfolios are worth more than ones with higher volatility, which therefore means that lower risk portfolios are also worth more than higher risk portfolios. Volatility, usually measured by the standard deviation of returns, is usually disclosed on portfolio or fund data sheets. It is times like these when it is important to know what it is and how it compares to its peers.