Choosing the Right Investment Products

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One of the most important elements in our investment planning is to be able to invest in the right investments so that we can achieve the desired returns within the level of risk we can assume. This will enable us to attain the desired retirement capital gap at retirement age or realize the amount of funds intended for a specific purpose such as a deposit for the purchase of a house or an education fund.

Achieving the targeted retirement capital gap on retirement is crucial so that our total retirement capital is sufficient for us to have a reasonable quality of life after retirement as we defined it when we drew up our retirement planning. Similarly, making sure to achieve a desired amount to be used as a deposit for property purchase at a particular point in time in our life is crucial so that we will be able to buy our own property at the right age. Likewise, ensuring an education fund reaches a desired level within a set period of time will help us sponsor the tertiary education of our offspring as well as to elevate our own education or technical qualification.

So what is the right investment? There is no one portfolio of investments that is suitable for everyone. The portfolio of investments is unique for each individual. And for an individual having targeted funds with different objectives and/or time frames, each portfolio of investments is also comparatively unique. Hence, there is no such thing as one fits all. But choosing the right portfolio of investments is a key ingredient to achieving the objective of investment planning. Therefore we need to be mindful and careful when we make our investment decisions.

BEST RETURNS VS SUPERIOR RETURNS VS RISK ADJUSTED RETURNS

Generally, when choosing an investment, there is a tendency among some of us to be attracted by the investment with the best return. An investment product that produced the best return the previous year may be the fund of choice for some of us, as other funds within the same category could not match such a return. This may be the easiest way of choosing a fund for us to invest. But, is this the right way? What happens next year if the fund – let us name it Fund A – no longer produces the best return this year? Should we then dispose of the investment and move to another fund – Fund B - that produces the best return this year? And should we continue to do

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the same year-in year-out the same way if we buy after it became the best fund and sell after it did not manage to be the best fund? This would be a decision based on an after event.

Having such an attitude towards performance may also give rise to the risk of us being trapped in Get Rich Quick Schemes. About 10 percent of the rural population in Malaysia was found to participate in such schemes each month[1]. Such schemes normally promise returns that are exceptionally high, calculated on a monthly basis – such as 5% per month or even 10% per month. The good experience of friends and relatives in such schemes over the last 3 to 6 months may entice us to believe in the scheme and ; hence the investment in such a scheme, only to realize later that this is a "robbing Peter to pay Paul" kind of scheme which cannot be sustainable and later goes bust.

What we as investors should look for is superior returns. Superior returns means better than average, or better than others of the same type . In seeking superior returns, we do not only look at the best; we also look at those that are better than average performers, or we may look only at the top 5 or top 10 within the same league. This will also lead us to have a wider choice of funds, which is good as it allows us to diversify our investment, making us not only have an investment product but also a portfolio of investment products.

Taking a step further, a professional investor or advisor will assess fund performance not only from the standpoint of returns alone, but also from the perspective of risks that are assumed in order to produce such returns. This is important as seeking returns beyond the risk free rate of return requires the assumption of risk. The higher the risk, the higher the expected returns, as the risk reflects the potential of the investment losing money as well. Therefore, we need to ascertain the extra return produced for each unit of risk assumed by an investment fund; hence the principle of risk-adjusted return. Risk-adjusted return is an investment's return by measuring how much risk is involved in producing that return[3].

ASSESSING RISK TOLERANCE

Before we go further, it is best to assess our own risk appetite or our risk tolerance level. There is no point of talking about investment risk without knowing to what extent we are willing to assume the risk. But what is risk? According to Economic Times, investment risk is the probability or likelihood of occurrence of losses relative to the expected return

[1]Berita Harian, 4 March 2012, quotation, as reported, by the then Minister of Domestic Trade, Co-operatives and Consumerism, Datuk Seri Ismail Sabri Yaakob.

[2]Cambridge Dictionary, http://dictionary.cambridge.org/us/dictionary/english/superior.

[3]http://www.investopedia.com/terms/r/riskadjustedreturn.asp.

on any particular investment[4] while the Cambridge English Dictionary defines it as the chance of losing money from a particular investment[5].

Many of us wrongly go by the adage "the higher the risk, the higher the return" when it should be "the higher the risk, the higher the expected return". When we use the former, we will be under the impression that assuming higher risk will definitely lead to achieving higher return, which is wrong. However, the latter is true as the higher return is an expectation as a result of assuming a higher level of risk; hence making us realize that achieving positive return is not an absolute certainty.

Investment houses worldwide have various ways of conducting risk profiling of their respective clients so that recommendations or management of their accounts can be in line with their respective profiles.

Risk profiling is a process for finding the optimal level of investment risk of a person, taking into consideration the risk required, risk capacity and risk tolerance. Risk required is the risk associated with the return required to achieve the one's goals from the financial resources available; risk capacity is the level of financial risk one can afford to take, while risk tolerance is the level of risk one is comfortable with[6].

In Malaysia, the Securities Commission Malaysia made it compulsory in late 2012 for all companies that sell unlisted capital market products such as unit trust funds and wholesale funds to conduct what it terms "Suitability Assessment" on their clients. The suitability assessment is an exercise carried out by a product distributor that would entail the product distributor gathering necessary information from the investor in order to form a reasonable basis for his or her recommendation[7]. A Suitability Assessment exercise comprises the following stages: gathering information pertaining to an investor, analysing information gathered, matching a suitable product to meet an investor's risk profile and needs, and making a recommendation[8].

To enable us to know our risk profiling, it is best for us to go through the questions set by professionals and used by investment houses that come together with a grading scheme. This process is very important to enable us to invest in a portfolio of investments or a portfolio of investment products that have a risk level which approximates

[4]http://economictimes.indiatimes.com/definition/investment-risk.

[5]http://dictionary.cambridge.org/dictionary/english/investment-risk.

[6]https://riskprofiling.com/riskprofiling/what-is-risk-profiling.

[7]Guidelines on Sale Practices of Unlisted Capital Market Products, Securities Commission Malaysia, Issued: 28 December 2012, Updated: 29 March 2013.

ours. The assessment will show whether we fall within the very high, high, moderate or low risk taker category or we are totally risk averse.

RISK ASSESSMENT OF INVESTMENT PRODUCTS

A popular measurement of risk for an investment or investment product is the standard deviation of the investment return. It measures the dispersion of a series of returns of the investment products from the average return. It is therefore a measure of volatility; hence the risk.

The Federation of Investment Managers Malaysia (FIMM), an association for unit trust management companies in Malaysia and a recognized self-regulatory body for its members, makes it compulsory for its members to publish the "volatility factor" of their funds in any notices that publish the performance figures of the funds except for notices published through sound broadcasting, film or television. According to its Investment Management Standard (IMS) that was issued in 2009, "volatility factor" is the annualized standard deviation on unit trust schemes/ recognized funds month-end returns for the immediate preceding 36 months and will be used as the main measurement for volatility[9].

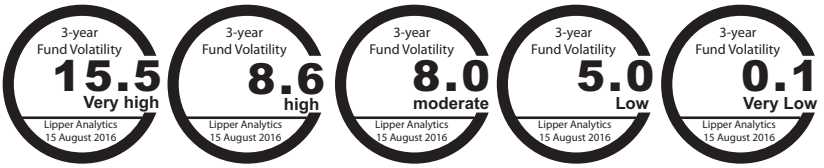
The volatility factor has two elements – the first is the 3-year annualized standard deviation of the monthly performance of a fund or called Fund Volatility Factor (FVF), and the second is the FIMM-Lipper Fund Volatility Classification (FVC) of Very Low, Low, Moderate, High and Very High in terms of volatility of a fund relative to all qualified funds that are evenly divided into five classes. The FVC is subject to revision every six months. What is interesting here is that we as investors do not have to calculate the volatility of the funds as it is already provided on a silver platter. We just need to find out where to obtain the information.

Both the FVFs and our risk tolerance level will enable us to gauge if funds are suitable or not suitable for us in terms of risk level. If we are assessed as a high risk taker, then we should invest only in investment products that have FVC of high risk. Alternatively, we can also invest in multiple investment products with different FVCs so long as the risk of the portfolio of the investment products is within the range of high risk FVC. The important point is we neither over expose ourselves to investment risks more than what we can assume so that we can take it when there is any reversal in the investment market that goes against us. Neither should we under expose ourselves to investment

[8]Ibid

[9]FMUTM/IMS (R&D)-009: Measuring and Disclosure of Volatility For Unit Trust Schemes and Recognized Funds, Federation of Investment Managers Malaysia (FIMM), Issued 27 February 2009, Effective Date: 1 May 2009

Examples of Volatility Factor and Volatility Class Icons are as follows:



risk less than what we can assume to ensure we can earn returns that are commensurate with our risk tolerance level.

Optimizing Investment Returns In Selecting Investment Funds

Once we know our own risk profiling, including the level of investment risk we can tolerate and the returns and risks of investment funds are made available in the periodic fund factsheets that are easily downloadable from the websites of the respective fund houses, what should we do next?

We would certainly be happy if we were able to enjoy higher returns given the same level of risks, wouldn't we? For an example, if the expected return of Fund M is 10% and that of Fund N is 11% and both have the same volatility and therefore the same risk level, we would certainly invest in Fund N. From another perspective, if the volatility of Fund K is higher than that of Fund L and both have the same expected returns, we would certainly invest in Fund L. The critical point here is that we want to optimize the returns that our investment portfolio can produce as we can only assume a certain level of risk.

To achieve the findings, we then apply the Sharpe Ratio, which is a measure of an investment's excess return, above the risk-free rate, per unit of standard deviation, with the following formula. Derived in 1966 by William Sharpe, it looks for investments with a ratio of more than 1.

$$\text{Sharp Ratio} = \frac{R_p - R_f}{SD_p}$$

Where R_p = Return of the fund in question

R_f = Risk-free rate of return

SD_p = Standard deviation of the fund in question

As the unit trust industry in Malaysia produces a 36-month annualized volatility for all funds that have a life span of at least three years, we can then compare this with the 3-year annualized return of the funds. Since we are forgoing the potential of obtaining a return over the period of three years without us having to assume any risk, or what is normally termed as opportunity cost, we will then use the 3-year deposit rate as the risk-free rate of return.

[10]http://www.investopedia.com/terms/r/riskadjustedreturn.asp

Suppose that we find nine funds that invest in the same asset classes and have annualized returns as listed in Column 2 of the table below. The funds are arranged according to their annualized returns. This is not the "average annual return" as understood by some of us. A 60% total return over a three-year period is not a return of 20% per annum, just because we can easily divide 60 with 3 because a 20% return per annum over a three-year period means a total return of 72.8%, i.e. [(1.2 x 1.2 x 1.2) – 1] x 100%. A total return of 60% over three years means an annualized return of 17.0% per annum, i.e. $[(1.6)^{1/3} - 1] \times 100\%$.

Column 3 tells us the risk of the portfolios in the form of volatility factor, which is essentially the standard deviation of returns that we discussed earlier. A higher volatility factor does not necessarily produce higher returns; similarly, a higher return does not necessarily require a higher volatility factor. One point to note is that the funds must continue to invest in the same asset class over the period under review; otherwise, the return-risk preposition will be compromised, making the study unacceptable.

Column 4 categorizes the funds into three different classes – three each in very high risk, high risk and moderate risk level. We do not list funds with lower volatility class because they are associated with funds that invest in other asset classes of lower risk level such as fixed income and money market while the nine funds in the table are equity funds. In addition, this study is intended to be as simple as possible.

Column 5 lists the risk-free rate in the market place for a period similar to the fund return and volatility. Column 6 is the Sharpe Ratio, the formula of which is shown earlier.

Table 1: Sharpe Ratio of Funds

Fund	3-Year Annualized Return	3-Year Annualized Volatility	Fund Volatility Class	3-Year Risk-Free Annualized Return	Sharpe Ratio
P	16.0%	14.0%	Very High	3.4%	0.90
Q	15.7%	12.1%	Very High	3.4%	1.02
R	14.5%	10.0%	High	3.4%	1.11
S	13.7%	10.5%	High	3.4%	0.98
T	12.9%	11.3%	Very High	3.4%	0.84
U	11.9%	8.2%	Moderate	3.4%	1.03
V	11.1%	9.5%	High	3.4%	0.81
W	10.2%	7.7%	Moderate	3.4%	0.89
X	9.1%	8.0%	Moderate	3.4%	0.72

**** The figures and FVCs are not actual.***

The main strength of Sharpe Ratio is to find funds that produce relative return, which is the difference between the fund's return and the risk-free rate, in excess of its risk. Based on this and from the examples in the table above, there are only three funds that are worth investing in – Fund R which is the best with a Sharpe Ratio of 1.11, followed by Fund U at 1.03 and Fund Q at 1.02. The worst of the nine funds from the Sharpe Ratio perspective is Fund X with a ratio of only 0.72.

If our risk profile is very high, then we will be able to invest in all the three funds – Funds R, Q, U. We may also consider investing in Fund S as its Sharpe Ratio is only a small fraction less than 1 and they produce relatively high annualized return. If our risk profile is high, we then have two funds to invest in, which are Fund R and Fund U, and possibly Fund S. If our profile is moderate, Fund U shall be our only choice.

In essence, the application of Sharpe Ratio in selecting the right investment funds for us will enable us to make the right investment decision given the expected returns and risks associated to producing such returns.

CONCLUSION

Investing in funds with the highest returns may not necessarily be the right decision and investing in a fund with a relatively lower return may not necessarily be a wrong decision. Return should not be the main determinant when it comes to decision making. The element of risk of the funds in relation to the performance must be put into perspective to ensure that we make the right decision – investing in funds that can produce a certain level of returns given the certain level of risk we are willing to assume. I hope that the above explanation and examples will be beneficial to unit trust consultants when recommending an investment mix to their clients.

Other elements that we also need to consider, but which are not covered in this article, are to include the consistency of the funds' performance as well as the investment objective and strategy of the funds. ■