Keep your investments on track

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One of the best ways to explain investment risk is by comparing it to Formula One racing. Aside from the fact that these drivers race at speeds of up to 300km/h around twists and turns on the racecourse, they constantly have to assess risks, such as when the time comes to speed up and when to slow down. A driver like Lewis Hamilton can start the race and keep going at full speed to get ahead of his competitors, but he risks the fact that his car's engine or its tyres may not be able to hold up to the challenge for the entire race.

At some point the driver in front will have to consider whether or not to continue racing at that particular speed and level, or whether to rather slow down a bit in order to spare the vehicle. Luckily, the driver has a team of experts to determine the vehicle's optimum performance levels within which to remain.

Investments in different asset classes are based on the same principle. Between 2011 and 2014, investors enjoyed being in the lead with their investments comfortably outperforming risk-free money market rates. Following the market's decline and increasing pressure this past month however, the time has come for investors to ask themselves whether they should slow down after having been in the lead for quite some time. Is it really necessary to keep pushing investments above optimum levels in order to win?

Before answering that question, it's important to clarify exactly what the optimum levels across the different asset classes are. Let's do this by using historical values and compare those to Inflation (CPI). The moment we refer to different asset classes, most investors will argue that shares offer the best vehicle to outperform inflation. What's interesting though, is that if an investor invested parts of their capital in local shares, local bonds, property shares and money market 25 years ago (1991), it is property shares that would have performed the best before taxes.

However, it is important to note that property shares also started from a low base. Shares still offer the most tax-efficient investment vehicle of the four mentioned above, but even after tax, investors would have only just won the race.

It's only when we take a look at the volatility of these investments that the race starts to change course. The money market was in the lead with an annual standard deviation of 1%. Bonds came in second with 8.4%, properties third with 17.8% and shares in last place with 18.7%. Standard deviation tells us (based on historical data) by what percentage our investment could have grown or declined over a 12-month period. This means that investors who invested in shares during this 25-year period, could have either seen 18.7% growth in capital value, or risked losing 18.7% of their capital value, which changes things quite significantly.

What this tells us is that if an investor aimed at outperforming bonds by 2%, they should have been prepared to risk losing 10% of their capital over the following 12-month period before continuing the chase after an asset class such as bonds.

With high risks and ratings still prevailing in current market conditions, investors have to ask themselves whether it is still necessary to push their investment ve-?hicles beyond their limits to stay in the lead.

An overweight position in any asset class or even in a specific investment remains dangerous. As with Formula One drivers, the solution for investors is to remain within the limits set by their team of experts.

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