Investing Essentials:

Rethinking Risk

Risk can be defined as “the possibility of something bad happening”. It’s an important consideration in many of our decisions and often most of us will try and reduce it or avoid it when we can.

While avoiding risk can often be the most sensible thing to do, in the context of investing, avoiding risk altogether may expose you to other, less obvious, risks. Successful investing depends on understanding key risk factors long-term investors face, how they can be managed, and assessing your own capacity and tolerance for risk.

> **“Successful investing is about managing risk, not avoiding it.”**
>
> – Benjamin Graham

Risk can be a loaded term when it comes to investing and is often misunderstood. You often hear about risk and volatility interchangeably in investing; while the two concepts are related, they don’t mean the same thing. **Risk** refers to the degree of uncertainty and/or potential financial loss inherent in an investment decision, whereas **volatility** measures how much the return of an investment, or the broader market, fluctuates up and down.

This article puts different investment risks into perspective and explores the various ways they can be managed.

Understanding investment risks

1. Inflation Risk

Have you ever heard someone say, “When I was your age that only cost a dollar”? They are referring to inflation – the general increase of average prices in an economy, accompanied by a decrease in the purchasing power of money. When saving for a long-term goal, we typically plan for the future while being very much rooted in the present. But the cost of goods and services – everything from groceries, to your morning coffee – will look quite different by the time you retire compared to when you started saving. Factoring in inflation is an important consideration when completing a financial plan.

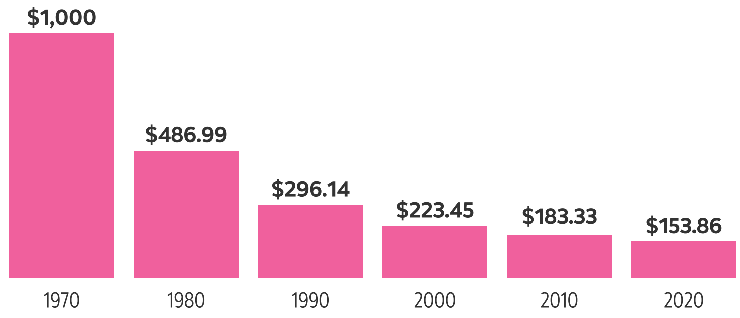
> **“A nickel ain’t worth a dime anymore.”**
>
> – Yogi Berra

Cash can be a drag

Investors who earn less than the rate of inflation are challenged by reduced purchasing power over the long term.

You may have greater exposure to inflation risk if all your savings are primarily sitting in cash. With today’s low interest rates, a cash-heavy portfolio can generate a negative real return after taking inflation (and taxes) into account. While this approach makes sense for short-term savings, an overly conservative investment approach can hinder growth potential and increase the risk of falling short of your long-term goals.

Erosion of purchasing power of $1,000 after 30 years due to inflation



Source: Statistics Canada. Core Canadian CPI from December 31, 1970 to November 30, 2020.

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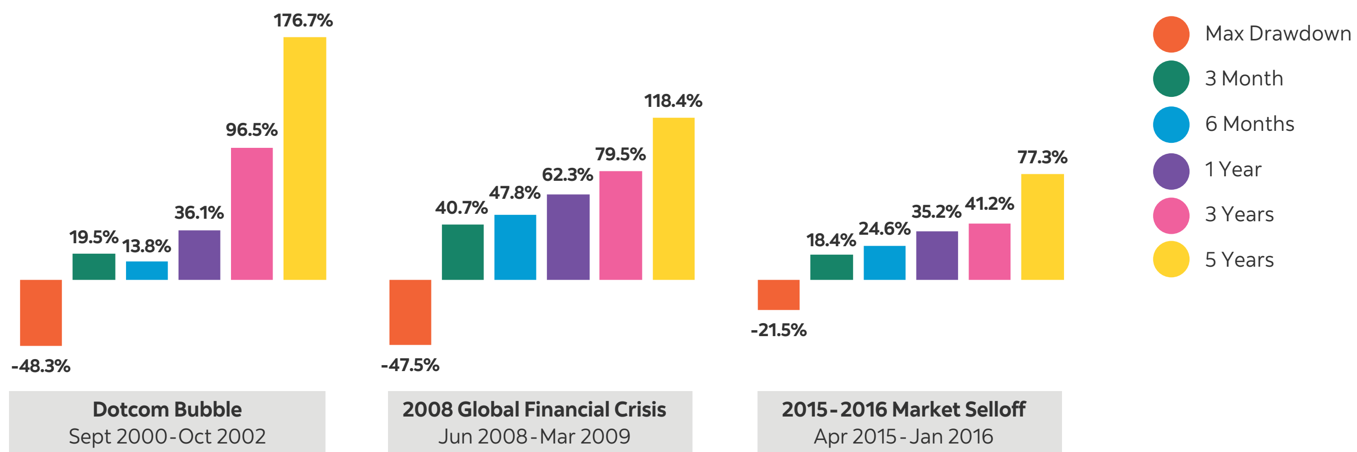
2. Market Risk

Market risk is associated with fluctuations in the market as a whole, rather than a single stock or a business sector. Typically, when we think about market risk, we can become very focused on the day-to-day movements in the markets and the corresponding change in the value of our investments, with a heavy emphasis on recent activity. However, when you look at the markets through a wider lens, the picture offers greater optimism. From the chart below, it's clear that downturns have historically been followed by sharp recoveries. While it can be tempting to flee to the relative safety of cash during periods of volatility, remaining disciplined and staying focused on your long-term goals usually nets a better result than attempting to time the markets.

Key Resource

Market volatility can be unsettling for even the savviest of investors. For tips on how to manage – and potentially benefit from – market volatility, check out 5 Timeless Tips on Managing Market Ups and Downs.

Canadian stocks after major market downturns



Source: Bloomberg and Morningstar Direct. Daily returns are based upon sell-off period during noted market corrections from the TSX Composite Index (CAD). Returns are not annualized. Indices are not managed, and it is not possible to invest directly in an index. Assumes reinvestment of all income and no transaction costs, fees or taxes. This information is for illustrative purposes only.

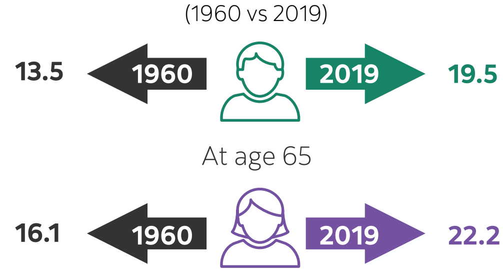
3. Longevity Risk

Outliving one's savings is a real risk for many, especially as life expectancies rise. The illustration on the right shows that an average female in Canada will spend 22 years (19 years for males) in retirement, but it's important to recognize that these numbers are just estimates and a sizable percentage of Canadians will end up living a great deal longer. With longer lifespans, your exposure to inflation risk, health risks and the risk of running out of money increases.

For many, outliving their retirement savings is a very real risk, but one that can be managed with proper planning and the right balance of investments for each stage of one's life.

Average Years Spent in Retirement in Canada

(1960 vs 2019)



Source: OECD (2021), Life expectancy at 65 (indicator).

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Managing Risk

It's important to remember that risk is an inherent part of investing. You cannot eliminate risk associated with investing, but you can certainly manage it. Here are some strategies to help you manage risk:

> **The biggest risk of all is not taking one.**
>
> – Mellody Hobson

Diversification – Don't put all your eggs in one basket

Diversifying a portfolio by combining different asset classes such as stocks, bonds, and cash equivalents – a process known as *asset allocation* – can help reduce your overall portfolio risk and lower the impact of day-to-day market volatility. This occurs when some assets perform poorly, their losses may be offset by others that are performing well.

The chart below shows the best to worst performing asset class each year since 2011. As you can see, no single asset class is consistently among the top performers, and the best and worst performers can change from one year to the next. A balanced portfolio with exposure to a variety of different asset classes provides the opportunity to participate in potential gains of each year's top performers, while aiming to lessen the negative impact of those at the bottom – smoothing out the ride.

Calendar year returns (in Canadian dollars)

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
HIGHEST	9.7%	16.0%	48.1%	23.9%	21.6%	35.4%	28.7%	7.7%	24.8%	17.9%
	8.3%	15.3%	41.3%	14.4%	19.5%	21.1%	17.4%	4.2%	22.9%	16.6%
	6.8%	13.8%	31.6%	11.2%	16.2%	17.1%	13.8%	2.5%	19.2%	16.3%
	4.6%	13.4%	13.3%	10.6%	14.6%	12.3%	9.1%	1.4%	19.2%	14.4%
	0.4%	7.9%	13.0%	9.7%	6.5%	8.2%	8.9%	-2.0%	16.5%	10.0%
	-1.8%	7.2%	7.8%	8.8%	4.4%	8.1%	8.2%	-3.0%	16.1%	9.4%
	-8.7%	3.6%	4.3%	7.0%	3.5%	7.7%	7.1%	-5.6%	12.9%	8.7%
	-9.6%	3.1%	3.9%	5.4%	2.4%	1.7%	6.4%	-6.5%	6.9%	7.3%
	-14.2%	2.5%	3.8%	4.1%	-8.3%	-1.5%	2.5%	-8.9%	1.5%	6.4%
LOWEST	-16.2%	2.0%	-1.2%	-0.1%	-13.8%	-2.0%	0.3%	-18.2%	1.4%	5.6%

Asset class	Index
Canadian Small Cap	BMO Small Cap Index
U.S. Equities	S&P 500 Index
Canadian Equities	S&P/TSX Composite Total Return Index
Canadian Bonds	FTSE Canada Universe Bond Index
International Equities	MSCI EAFE Index
Emerging Markets	MSCI Emerging Markets Free Index
U.S. Small Cap	Russell 2000 Index
Global Bonds	Barclays Global Aggregate Bond Index
Canadian Home Prices	Teranet-National Bank Composite House Price Index - Composite 11
Balanced Portfolio	40% FTSE Canada Universe Bond Index, 30% S&P/TSX Composite Total Return Index, 30% MSCI World Index

Source: Morningstar. Priced in Canadian currency, as at December 31, 2020. Assumes reinvestment of all income and no transaction costs or taxes. Annual returns compounded monthly. The asset classes are represented by their indicated indices and the balanced portfolio is hypothetical in nature. This information is for illustrative purposes only. It is not possible to invest directly in an index.

> Each **Scotia Portfolio Solution** maintains an optimal asset mix consistent with each investor's risk tolerance, while active management and multi-level diversification take advantage of emerging opportunities while managing risk along the way.

Time – Use time to your advantage

Although contributing to long-term investments (e.g. retirement) is Canadians' leading financial priority[1], there always seems to be a good reason to delay saving. The reality is that time is your biggest ally when it comes to saving and it's never too early to start saving for retirement. You can start by contributing even a small amount each month. As you earn more later in your career, you can increase the amount. The earlier you start saving, the better off you'll be, as your money will have more time to benefit from compound growth.

[1] Scotiabank, Scotia Global Asset Management Investor Sentiment Survey, June 2021.

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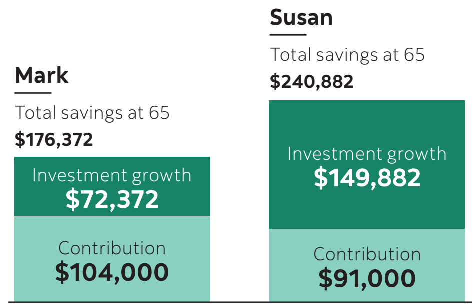
Time is on your side

Let's look at the impact of delaying saving for retirement. Susan and Mark would both like to retire at age 65. Susan starts saving $100 biweekly when she's 30. Mark decides to put off saving until he's 45 but will contribute twice as much – $200 biweekly – to help catch up.

At age 65, Susan will have contributed $91,000 in 35 years, while Mark will have contributed $104,000 in 20 years. However, Susan will retire with $64,510 more than Mark – even though she contributed $13,000 less. With more time on her side to grow her savings (15 years more) and the benefit of compound growth, Susan's $91,000 contribution grew to $240,882, while Mark's $104,000 contribution grew to $176,372 ($64,510 less than Susan).



For illustrative purposes only and not intended to reflect an actual rate of return of the future value of an actual mutual fund or any other investment. The calculation assumes reinvestment of all income and no transaction costs or taxes. Illustration assumes a hypothetical rate of return of 5%, compounded annually. Amounts are rounded to the nearest dollar.

Investing regularly and automatically with **Pre-authorized Contributions** (PAC) can help you build your savings easily and automatically.

Your risk tolerance and investing

The degree of risk you're willing to accept when investing is a critical factor in building a successful investment plan. Just like some people may find bungee jumping thrilling, others would rather have their feet on the ground. While an aggressive investment strategy can be too much for many to stomach, an overly conservative approach can hinder growth potential and increase the risk of falling short of goals, especially after factoring in inflation.

The bottom line: Having the right investment approach and asset allocation for your needs can help strike a balance and manage risk, instead of avoiding it.

Your Scotiabank advisor can help assess your risk tolerance and can help you put the elements of time, purchasing power, market, and longevity risk into perspective by building an investment plan tailored to your unique needs.

Contact your Scotiabank advisor today to get started.

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