It is the primary aim of this book to point out that Finance World has fundamentally and dramatically misunderstood the nature of investment risk. However before this can be done it is necessary to understand how Finance World calculates its own version of ‘risk’, and before that can be done it is necessary properly to understand return, because within the neat mathematical parameters of Finance World one (risk) is seen as a product of the other. Return is used to calculate risk. Remember that word ‘calculate’, by the way, for it is important.

We started to look in Chapter 6 at how return measures are calculated. We noted that periodic return measures are almost universal (save only for bonds, with which we will deal shortly) and that they suffer from some serious defects. We should now delve into these problem areas a little more deeply, since one of them will lead us naturally to consideration of a totally different way of viewing return.

*Periodic return measures do not reflect investment reality*

In Chapter 6 it was suggested that periodic return measures do not reflect the reality of a real life investor holding a real life investment. Since the main purpose of finance theory is to guide investors in the decisions that they make, this should be seen as a fundamental flaw. The first limb of this contention, that periodic return does not reflect reality, is in turn composed of two different yet closely related points.

First, periodic return measures force us to take account of contingent gains and losses as well as actual. They treat things
which have not happened and may never happen as though in fact they have happened. They take outcomes which are as yet uncertain, and cast them in stone.

Second, they are inconsistent with how an investor views the holding of an asset, or at least how an investor should view the holding of an asset. It has been accepted for many years that the value of any corporation, and therefore logically any share in any corporation, is dependent upon the cashflows which the business will generate in the future. These are of necessity uncertain, and require the use of projections based on sensible assumptions, but the principle is not in doubt. Yet periodic return measures prefer notional gains and losses over cashflows.

The first point was deliberately stated very baldly so as not to confuse the issue by having to hedge it about with all sorts of qualifications. It should be conceded at once that there are some situations where little harm is done by using them, or even where we have no effective alternative. What is harmful is that people use periodic return measures without stopping to think about the various contingent elements which go into their preparation.

There are two main types of situation where the use of periodic return is fairly unobjectionable. The first is where there is an absolute requirement to plug a number into something as at a particular date. The second is where an investor has a genuinely short-term time horizon.

If you need to prepare the accounts of an investment company, or a pension fund, or measure the performance of an investment manager, then it is all very well being intellectually pure and saying ‘but we don’t know yet what the final outcome will be; we’ll let you know when we sell’ because that simply is not an option. There is a need for a figure today, often as a legal or procedural requirement, and the only number that is both available and appropriate is normally a periodic return.

The ‘mark to market’ provisions of accounting standards and pension regulations would be a case in point. If a public market exists for an asset then it is difficult to see how a photograph of its formal valuation at a particular second in time