Monthly Newsletter
Savings and Investments
Strong month in financial markets

March 2015

Market overview

Financial markets were really strong last month. Among the main reasons were agreement in principle between Greece and the European Union (EU), European Central Bank's (ECB) approach towards bonds buying programme (QE), agreement on ceasefire in Ukraine (which was violated shortly), speculations that first Federal Reserve (Fed) rate rise may not come until September (instead of June as previously expected) and stabilized oil prices. Despite strong stock market performance, equities seem to remain attractive as US growth and central banks liquidity worldwide continue to remain supportive for riskier assets.

Stock market performance*	Major events and expectations
USA (S&P 500 index, USD): **+5,5%** in February **+2,2%** YTD **+90,5%** in 5 years **Europe** (MSCI EURO, EUR): **+7,3%** in February **+15,0%** YTD **+43,2%** in 5 years **Eastern Europe** (MSCI EM Eastern Europe, USD): **+15,5%** in February **+13,1%** YTD **-32,6%** in 5 years **Asia** (MSCI EM Asia, USD): **+2,3%** in February **+4,8%** YTD **+27,2%** in 5 years **Latin America** (MSCI EM Latin America, USD): **+3,9%** in February **-2,7%** YTD **-32,0%** in 5 years	**In US, the outlook for interest rates looks set to continue to drive market sentiment over the coming months.** Along all the focus when Fed will start rate hike, another important issue is the pace of rate rises. On this the Fed is signaling a very gradual and gentle path higher. After Fed Chair Janet Yellen's semi-annual monetary policy testimony at the end of February the conclusion was that analysts who think That inflation in US will soon begin climbing faster have reason to believe in early initial rate hike, while those who foresee unexpectedly low inflation for an extended period predict that first rate hike will come later. SEB's forecast for the first Fed rate hike is September 2015. Latest core inflation (which excludes food and energy) data shows 0,2% increase in prices in January (stronger than expected). Fed's target level is 2%. US economic growth for the Q4 of 2014 was revised down from 2,6% to 2,2%, due to a slower-than-expected rise in business inventory investment. Other macro data continue to be strengthening. **ECB began its expanded QE programme**, consisting of monthly purchases of bonds and other securities or loans totaling EUR 60 billion, including EUR 40 billion worth government bonds. One question is how German government will be affected during the coming year when ECB will be buying EUR 120 billion worth, while net issues of German government bonds will be less than EYR 10 billion. Today German government bonds with maturities of up to 7 years carry negative yields. SEB's forecast is that other factors, such as stronger economic conditions and heightened inflation expectations, may still cause euro zone government bond yields to climb gradually in the coming months. Latest macro data (growth in euro zone business activity, better than expected trends in consumer price index, continued rise in lending, rise in consumer confidence) show more concrete signs of improvement in the real economy. **Greek drama unfolded throughout with agreement in principle between Greece and the EU** to extend the country's current financial bail-out programme by four months with a condition that Greek government must submit package of reform measures for approval by the European Commission, ECB and International Monetary Fund. Greek government did prepare a list of proposed reforms and budget-improving measures. Final approval will be delayed until April. Until then, Greece will not receive the remaining EUR 7,2 billion from its extended loan programme, which runs until June 30. Elsewhere in the world. If Minsk agreement on ceasefire in Ukraine is seriously violated, **European leaders stand ready to prepare and impose further sanctions on Moscow for supporting the separatists**. **China set the lowest economic growth target in more than 15 years** from 7,5% in 2014 to 7,0% this year. The government lowers its growth target to focus more on the quality than the quantity of growth. However, **People's Bank of China is ready to undertake further monetary policy easing** measures to support economic growth. Bank of Japan's (BoJ) governor H. Kuroda commented that **BoJ would ease policy further if its 2% inflation target becomes seemingly more unreachable.**

* More information regarding indexes' performance can be found at the end of the document

Impact on product groups of different risk categories

Product group	Impact during the last month and expectations looking forward
Low risk (conservative)	Recovery and stabilisation in oil prices was one of the reasons US bond yields rose during February. Euro zone government bond yields remained at continued downside pressure mainly because of ECB bonds purchase programme launch this month. More and more euro zone government bonds enter the negative yield territory and yields may remain at record lows for a while. However, stronger economic conditions and heightened inflation expectations as well changes in expectations towards Fed interest rate hikes may still cause euro zone government bond yields to climb gradually in the coming months.
Medium risk (balanced)	February was the second great month in a row for our balanced medium risk portfolios mainly because of taken advantage in the rise of equity markets and high yield (HY) bonds. Expectations for high risk investments within balanced medium risk portfolios are covered in high risk part. Looking ahead, in the medium risk bond market – HY bonds – shorter duration HY bonds still appear to be the most attractive fixed income investments. Stabilized oil prices impacted price increases in the American HY market, thus it diminished a price increase potential a bit. On the other hand it decreased the uncertainty as well. European HY bonds still seem to be less risky and will provide lower yield but a more stable trend. Although we believe that global HY bonds will outperform IG and government bonds over the coming 12 months but we regard equities as relatively more attractive.
High risk (aggressive)	Stock markets performed superbly in February, especially in Europe. Rapid growth in share prices decreased potential a bit. However, assuming persistently strong US economic growth, a supply of liquidity from central banks and cheaper energy, there are reasons to expect stock markets to continue climbing. A long-lasting upturn will also require support from corporate earnings. The ECB's launch of expanded bond purchases looks set to support riskier assets in financial markets in the short term, and a weaker EUR will benefit euro zone exporters. We prefer broad investments in global equities. Among emerging markets, we continue to see the best potential in Asia (stimulus measures and other reforms suggest attractiveness in China).

SEB

Monthly theme

How to measure your risk tolerance

In previous monthly newsletter we wrote that in general investment risk means uncertainty of what will happen with money you invested. It refers to the possibility that you will lose your investment or that an investment will be less profitable than you expected. To be more specific, this uncertainty about the outcome of an investment means that investment risk refers to the way the price of an investment fluctuates in value from time to time – its price volatility. The higher the volatility, the greater the uncertainty about the outcome of your investment, and the greater the potential risk involved. Within this background of investment risk there are two important elements to understand. The first is the investor's own ability to tolerate risk, and the second is the risk of the investment itself. In this article you will learn more about it.

Investor's own ability to tolerate risk

Each individual is able to tolerate a different amount of investment risk. This is known as individual's risk tolerance which means individual's ability to endure investment volatility. Those who are comfortable taking more risk in exchange for the potential of higher return are referred to as risk tolerant. Those who can accept very little risk are known as risk averse. Investors typically fall into three categories of risk tolerance: conservative (those who would like to refuse risk or accept only low risk even if return is very little), aggressive (those who are seeking higher potential return even if volatility is high) and moderate (those who are somewhere in between). How comfortable an investor is with taking risk depends on many factors, including investor's objectives and goals, life stage, personality, education, occupation, knowledge of investing, experience in investing and financial capacity.

The first step in evaluating your risk tolerance should start from clearly defining your financial goals. For example, if you are young and plan investments for your financial needs in retirement, you may be willing to assume more risk in exchange for a higher expected return. On the other hand, if you plan to use invested money in short term, for example, you have children who are reaching higher education in few years, you may not want to put money into high risk investments. It is related to investment horizon – the sooner you may need to use your investments, the lower your risk tolerance will probably be. Clarifying the reasons you want to invest can be a key component in determining what level of risk you are comfortable to assume. Answering the questions like – what do you plan to do with money you invest, how much money will you need, when will you need the money, can you afford to lose the principal – may help you to assess your financial goals.

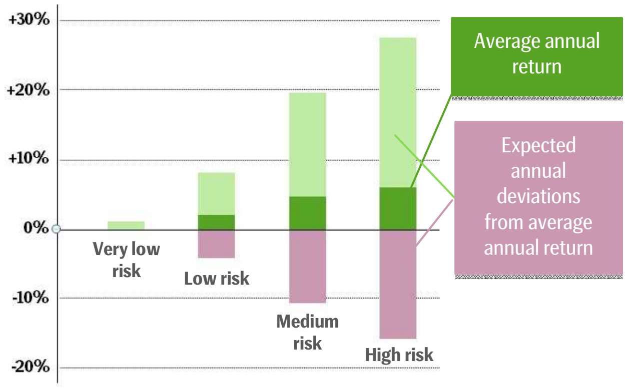
When it comes to personality, some investors may stay with an investment during downturns in the market, while others will run out at the first sign of trouble. If you find yourself that you can't sleep at night worrying about your hard-earned money at risk in a particular investment, you may have invested too aggressively. The other thing is that it might be easy to tolerate a high risk investment when it is generating solid returns, but consider whether you will feel the same if the market goes down and you will start losing on your investments. You should only take a risk that you are comfortable with or, in other words, you should invest at a level of volatility that you are comfortable with.

Along with the personality and investor's desire to assume risk, financial capacity to assume risk has to be considered as well. An investor's capacity for risk is looked from a financial point of view. Assets and expenses are the key components here. If investor has no reserves and no assets or depends on investments to pay daily expenses, has to be less risky and save up for the reserves at first.

Investor's risk tolerance is highly individual and subjective, depending on a number of factors. Thus, an investor's risk tolerance is not static and may change over the course of life as the factors change. An example could be the increases or decreases in family obligations, major shifts in the economy or other such circumstances. Therefore, it is wise to review your financial goals and risk tolerance on regular basis (recommended at least once per year) and be prepared to modify it if needed.

Risk tolerance testing

Tests are the tools that are used to assess investors' risk tolerance. Typically it is a questionnaire with questions about investor's current financial situation, goals, past investment experience. But it is not all about it as the important part of it is to gauge investor's attitude toward risk. Therefore usually there is a psychological part with questions about feelings or behavior in different situations. It also might be illustrated questions asking to choose acceptable level of investment's price fluctuation. Example is in a picture below.



The purpose of the question in example is to show that with higher expected return higher fluctuations are possible. Seeing both positive and negative side of possible deviations from expected return investor can choose the level of risk he or she is comfortable to assume.

Matching investor's risk tolerance with investment's risk

Understanding investor's risk tolerance is important, because it is one of the basic factors in determining the best investment solution which would match investor's risk and return expectations. On the other hand, it is important to understand for investor himself how his tolerated risk matches with the investments he or she chooses or is offered to choose.

There are developed ways how to measure risk. And here we come back to understanding that risk equals volatility. The higher the volatility, the higher the risk, but also the potential for a higher rate of return. The standardized measurement of volatility is called standard deviation which is usually calculated on annual basis and is used to gauge how far away from the average the return rate for any one year in the future is likely to be. If such practice is adapted in how risk is measured and how it is explained to investors, both the risk tolerance question and the risk of investment itself have to be tied to it. The example of risk tolerance question in the picture illustrates this practice. There investor chooses with what volatility he or she is comfortable with, and investments he or she chooses or is offered to choose have to be tied to the same risk levels.

Conclusion

Risk tolerance means individual's ability to endure investment volatility. Investor's own ability to tolerate risk means understanding how comfortable an investor is with taking risk. It depends on many factors such as financial goals, life stage, personality, education, occupation, knowledge of investing, experience in investing and financial capacity to assume risk. Investor's risk tolerance is not a static and may change over the course of life as the factors change. Risk tolerance is assessed by adopting questionnaires which help to gauge investor's attitude toward risk. Understanding investor's risk tolerance is the basic factor in determining the best investment solution which would match investor's risk and return expectations. The way how risk is explained to investor and how it is measured in investments practically have to be the same.

Sources: Forbes, FlexScore, Investopedia, Besley and Brigham, "Principles of Finance" (3rd edition)

Terminology explanation

Terminology used	Explanation
Gross Domestic Product (GDP)	The monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.
Duration	A measure of the sensitivity of the price of a bond to a change in interest rates. Duration is expressed as a number of years. Rising interest rates mean falling bond prices, while declining interest rates mean rising bond prices. The duration number is a complicated calculation involving present value, yield, coupon, final maturity and other features. Fortunately for investors, this indicator is a standard data point provided in the presentation of comprehensive bond and bond mutual fund information. The bigger the duration number, the greater the interest-rate risk or reward for bond prices.
Deflation	A general decline in prices of goods and services. Deflation can be caused by a reduction in the supply of money, also by a decrease in government or personal spending. The opposite of inflation, deflation has the side effect of increased unemployment since there is a lower level of demand in the economy, which can lead to an economic depression. Central banks attempt to stop severe deflation, along with severe inflation, in an attempt to keep the excessive drop in prices to a minimum.
International Monetary Fund (IMF)	The IMF is an organization of 188 countries whose stated objectives are to promote international economic co-operation, international trade, employment, and exchange rate stability, including by making financial resources available to member countries to meet balance of payments needs. The IMF provides technical assistance and training for countries requesting it.
Investment grade bonds, high yield bonds	Investment grade bonds – bonds (sovereign or corporate) with credit ratings that indicate a relatively low risk of default. High yield bonds – bonds (sovereign or corporate) with credit ratings that indicate a relatively higher risk of default than investment grade bonds. Because of the higher risk of default, these bonds pay a higher yield than investment grade bonds. Two main credit rating agencies Standard & Poor's (S&P) and Moody's, use different designations consisting of upper- and lower-case letters 'A' and 'B' to identify a bond's credit quality rating. S&P designations of 'AAA' and 'AA' (high credit quality) and 'A' and 'BBB' (medium credit quality) are considered investment grade. Credit ratings for bonds below these designations ('BB', 'B', 'CCC', etc.) are considered low credit quality, and are commonly referred to as high yield or "junk bonds".
Maturity	The period of time for which a financial instrument remains outstanding. Maturity refers to a finite time period at the end of which the financial instrument will cease to exist and the principal is repaid with interest. The term is most commonly used in the context of fixed income investments, such as bonds and deposits.
Quantitative easing (QE)	An unconventional monetary policy in which a central bank purchases government securities or other securities from the market in order to lower interest rates and increase the money supply. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.
Standard deviation	In finance, standard deviation is applied to the annual rate of return of an investment to measure the investment's volatility. Standard deviation is also known as historical volatility and is used by investors as a gauge for the amount of expected volatility.
Yield	The income return on an investment. This refers to the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value.

Stock market indexes performance information covering the immediately preceding 5 years till 28 February, 2015

Region	Index	Currency	Performance						
			2010	2011	2012	2013	2014	12 months	2015 YTD
USA	S&P 500	USD	12,8%	0,0%	13,4%	29,6%	11,4%	13,2%	2,2%
Europe	MSCI EURO	EUR	-2,2%	-16,5%	15,6%	19,6%	2,3%	15,8%	15,0%
Eastern Europe	MSCI EM Eastern Europe	USD	13,7%	-23,3%	13,2%	-2,9%	-40,0%	-26,2%	13,1%
Asia	MSCI EM Asia	USD	16,6%	-19,1%	18,1%	-0,2%	2,5%	9,4%	4,8%
Latin America	MSCI EM Latin America	USD	12,1%	-21,9%	5,4%	-15,7%	-14,8%	-9,7%	-2,7%