Understanding the Risks of Investing in UITFs

For majority of UITF investors, May 2006 was the watershed month that dealt them first-hand knowledge of how market risks and volatility could affect the value of their investments. After over a year of basking in double-digit returns, UITF participants suddenly found themselves looking not only at the prospect of pared earnings, but, more dreadfully, the loss of a part of their principal. Rising global and domestic interest rates reduced the values of the UITFs' underlying assets, pulling UITF NAVPUs down and alarming some investors into cutting short their intended time horizon and redeeming their participations, even when this means realizing some losses.

On the other hand, there are some investors who made the conscious choice to stay invested in the UITFs, taking comfort in the knowledge that recovery is, somewhere along the line, in the offing, even inevitable. These investors recognize that since these funds are generally long-term in nature, fluctuations in NAVPUs could not be helped and thus should not distract them from their long-term view of the markets. These are the investors who are aware of the risks inherent in investing. As such, they are the ones who stand a better chance of enjoying its rewards or, at the very least, of sleeping better at night instead of constantly grinding their teeth over the fate of their fortunes.

One of the most famous investment gurus of our age, Peter Lynch, once said that the organ needed for successful investing is not the brain nor the heart, but the stomach. Having the stomach for risk – in other words, accepting its existence – is, therefore, a prerequisite of investing. Any sane investor given a choice would go for risk-free investments. Unfortunately, there is no such thing. Whether we like it or not, risk will always be part of investing. Even money kept in savings accounts could be at risk because inflation could at any time overtake the savings rate and diminish such money's purchasing power. Thus, to think that UITFs are exempt from risk is just plain unrealistic.

After acknowledging the inevitability of risk, the next step to successful investing is to know the proverbial "enemy" - become acquainted with different kinds of risks attendant to UITFs so that you could be properly guided in your choices and decisions. These are some of the risks you should be aware of:

Interest Rate Risk

Changes in interest rates affect the value of fixed income investments such as bonds, which are among the components of most UITFs. When interest rates rise, bond prices fall and, conversely, when interest rates decline, bond prices rise. As the prices of bonds comprising a UITF adjust to changes in interest rates, the fund's share price may rise or decline accordingly. Even government securities, although considered credit risk-free, are subject to interest rate risk.

Market/Price Risk

This refers to the risk that the UITF could lose value due to a decline in securities prices, which may sometimes happen rapidly or unpredictably. The value of investments fluctuate over a given time period because of general market conditions, economic changes or other events that impact large portions of the market such as political events, natural calamities, etc.

Liquidity Risk

This describes the risk that certain securities in the UITF portfolio may be difficult or impossible to sell at a particular time or, if sold, will affect market prices substantially. This could delay the redemption of investments in UITF until its assets can be converted to cash. Even Government Securities, supposedly the most liquid of fixed income securities in the Philippine market, may be subject to liquidity risk particularly if sizeable volumes are involved. So far, despite the heavy selling of government securities in recent weeks, the market has provided the liquidity needed by the redemptions of UITFs.

Credit Risk

This is the risk that a UITF may lose value in the event the issuer of a bond included in its portfolio defaults or could default on his obligation. Such default will drive down the price of the issue and may make the security difficult to sell. As these happen, the UITF's NAVPU could decline in value. You can be sure that UITFs invested purely in government securities are free from this risk.

Counterparty Risk

This is the risk that a counterparty in the trading of the securities included in the UITF portfolio, for some reason fails to deliver the cash or securities on the agreed tradeUITFs minimize this risk by dealing only with accredited counterparties and keeping securities with independent third party custodians, as a regulatory requirement.

Accepting and being able to identify the risks involved in investing – **in short, knowing what you are getting into** - is just half the battle. The other half, while sounding merely intuitive, could be more difficult and complicated than the first. This entails knowing yourself as an investor - being able to honestly assess your own objectives, return requirements, investment horizon and risk tolerance. People have different understanding and appetites for risk. The key to stress-free investing is to take only the risks you are comfortable with. Obviously, how well you know yourself as an investor will determine your level of comfort.

Armed with this knowledge of what risk is and how it will impact your investing live, you can now look back at the UITF experience squarely and unemotionally.

While not immune to risks, UITFs are products formulated according to global standards and stringent regulatory policies. They are primarily designed to provide the investor a spectrum of investment alternatives that could match his own risk/return preferences. By requirement, each UITF is accompanied by a Declaration of Trust that embodies its investment objectives and policies. Ideally, the investor should be aware of these objectives and policies to make sure these match his own objectives and investment profile. A scrutiny of the Fund's declarations should provide a clue to what kind of risks it is allowed to take. For example, a money market fund may state that it is limiting its investments to short term investments of government and prime corporations. This limits the interest rate risk and the credit risk taken by the fund. On the other hand, a bond fund may state that it is invested in longer-term bonds but will limit its investments to government securities. This means the fund will be exposed to interest rate risk but not to credit risk because government securities are considered free of credit risk. An equity fund may be subject to market risk but will not be subject to credit or interest rate risk. Therefore, a simple inquiry into a UITF's policies could give the investor relevant insight regarding the Fund and its suitability to his own needs.

Once the nature of investments and the concept of risk as discussed above are fully understood, successful and stress-free investing should be the norm rather than the exception. After all, financial institutions came up with the UITFs to provide investment-minded participants access to outlets with the potential for higher-than-average yields within the framework of specific investment objectives and guidelines that allow investors to choose and limit their risks. Under the close supervision of the BSP that implemented ample safeguards to ensure professional standards for fund managers and to protect the participants, UITFs, despite the risks, remain sound and viable investments.