IN THIS REPORT

After a sharp decline in April, U.S. equities snapped back in May with robust returns across most asset classes. For many investors, the pain was softened by portfolios that did not look like the benchmark. With markets back up near their all-time highs, now is a good time to reflect on the risks we are taking, and which ones truly matter.

FOCUS PARTNERS

MONTHLY INVESTMENT COMMENTARY

JUNE 2025

Investors often talk about risk, but they rarely contemplate the question: the risk of what? That question changes everything. It distills surface-level thinking from something more foundational.

Absolute vs. Relative Risk: The Long-Term Investor's Dilemma

For many, risk becomes shorthand for volatility or underperformance. In some instances, risk is simply feeling uncomfortable with the direction of markets. In our experience, these reactions are just the symptoms.

Real risk, in our opinion, is the prospect of not achieving your objectives. We refer to this as an absolute risk. Oddly enough, individuals often choose the comfort of relative safety.

A Closer Look at the Terms

Let's start with some definitions:

- Relative risk is about how similar or different a portfolio looks from the target. It is measured by metrics such as tracking error (a portfolio's performance relative to a benchmark) or active share (a portfolio's holdings relative to a benchmark).
- Absolute risk, by contrast, focuses on outcomes. It is the risk of permanent impairment of capital or falling short of your long-term goals. It is about missing the mark, not because you deviated from the index, but because the index was inconsistent with your objectives.

The Temptation of the Benchmark

If absolute risk is a better measure of an investor's personal success, why do many investors prioritize relative risk?

Perhaps it's because investors prefer the immediate feedback they receive from benchmarks. Indices are published daily and are easily accessible. In an increasingly gamified world, they can serve as a ready-made scoreboard.

Benchmarks are certainly efficient. At their best, they reflect the combined wisdom of a wide range of rational investors carefully weighing the present value of future cash flows. At their worst, they are an emotional litmus test of investors' fear and greed. They become an incarnation of an age-old idiom: "If your friend jumped off a bridge, would you follow?"

For investors, the answer might depend on what is at the bottom. Is it a trampoline that will propel us higher than where

JASON BLACKWELL, CFA®
Chief Investment Strategist and a Principal of Focus Partners

we started, or a concrete slab that permanently impairs our ability to get back up?

Investors who minimize tracking error reduce the chance of looking wrong today, but in doing so, they may increase the chance of falling short tomorrow.

Our View: Both Measures of Risk Matter

The academic evidence tells us to pay attention to the benchmarks, which we certainly do. We use this to inform portfolio positioning, but it is not the sole determinant. Benchmarks help us understand where market participants see opportunity or risk. Most importantly, they force us to sharpen our viewpoints and clarify our convictions.

We are unwilling to follow the benchmark off a bridge, however, without first understanding what is at the bottom. We construct portfolios only after carefully analyzing the landing. As a result, we are willing to accept periods of divergence from benchmarks. We are comfortable with volatility if it comes with a higher expected return. Moreover, we don't mind looking different when the risk of being the same is too high.

All this underscores why time, discipline, and a focus on absolute outcomes remain an investor's greatest allies. **Relative risk guides us, but absolute risk governs us.**