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Consumer guide to investment risk

What is risk?

Risk is another word for uncertainty. While all investments carry an element of risk, the amount of risk you take directly affects any potential returns and losses. Generally, if there is less risk to your investment, the lower the potential return you can expect. Whereas the higher the risk, the greater the potential return but also the more the investment is likely to fluctuate in value and suffer potential losses.

Risk exists whenever you invest your money – even keeping money in the bank or under your mattress has risks associated with it. The key to successful investing is receiving the highest possible returns for the level of risk you are prepared to take. The skill of the adviser is helping you agree your risk "tolerance" and then recommend the correct investments to suit your circumstances and needs.

Types of investment risk

There are many different ways that risk that could affect an investment, the main ones are noted below:

Market risk	The risk that equity investments will fall in value due to falls in investment markets generally e.g. crash of 1987.
Investment specific risk / unsystemic risk	The risk that an investment will fall in value due to circumstances / events linked to a particular company / industry e.g. Toyota and its reliability issues.
Interest rate risk	The risk that an investment will fall in value (in real terms) as interest rates rise e.g. gilts.
Currency risk	The risk that investments or deposits in overseas companies will fall in real terms if Sterling becomes stronger.
Liquidity risk	The risk that an investment may be hard to sell e.g. commercial property. This may mean you cannot realise the monies when needed or the property has to be sold below market value, thereby creating a greater loss.
Default risk	The risk that companies will be unable to meet their repayment commitments e.g. Lehmans and Landsbanki.
Credit risk	The value of a fixed interest investment falls where the default risk is deemed to have increased.
Inflation risk	The risk that the purchasing power of savings will fall in real terms in times of high inflation e.g. deposit accounts.

Depending on how you decide to invest your money, some of the above risks may apply, but your adviser will attempt to limit these risks by selecting products and funds that minimise the risk. However, the risks can never be completely removed.

What level of risk are you prepared to take?

Saving or investing successfully is about balancing the risk you are prepared to take with your money to try and achieve the return you want (or need), whilst at the same time feeling comfortable with the approach you are taking.

No-one can tell you how much risk you should be happy with – this is a personal decision likely to be affected by your personality, your circumstances, your investment objectives and your personal experience. Your adviser will help you to establish the level of risk that is right for you.

What other factors might impact the level of risk taken?

Although understanding risk is not always straightforward, it may be worth considering some of the following factors to help you decide the level of risk you are willing to take:

Timescale	How long do you want to invest for? Short term investing can be more risky as losses may not be regained quickly.
Proportion of total assets	What proportion of your total wealth do you want to invest? Taking chances with large proportions of your money when you are relying on it is a risky strategy. You should ensure you have sufficient cash available to meet your everyday needs.
Inflation risk	Do you want to ensure that your investment beats inflation? If so, you will need to take some risk (or re-evaluate your expectations).
Past experience	Have you had previous investment experience? If not, how do you know how you would feel about losing money? Your past experiences (good and bad) may cloud your judgement and may influence your willingness to take risks in the future.
Knowledge	Do you understand investments? You should ensure you understand the risks you are taking before you invest – your adviser can help with this.
Purpose	What do you intend to do with the money you invest? You may be prepared to take more risk with surplus income that you can afford to lose than money designated as a deposit for a house, for example.

Once you have agreed with your adviser the level of risk you are prepared to take, the overriding investment decision should be based on your "capacity for loss", or in other words, the level of risk you can afford to take without it affecting your financial security. You should never take more risk than you can afford. For example:

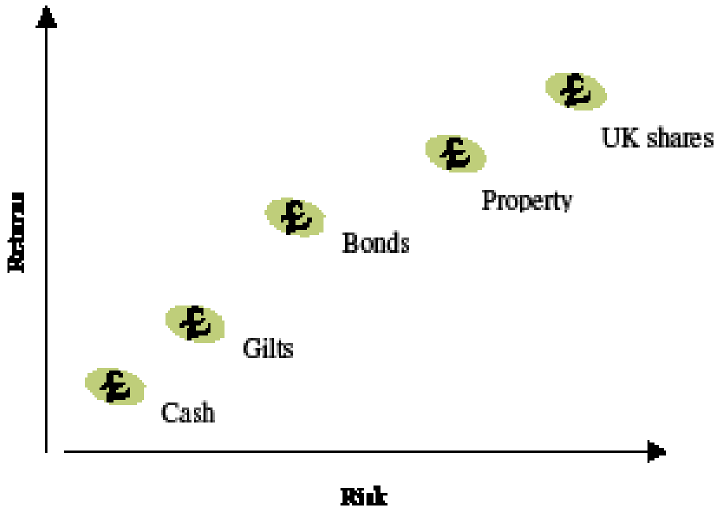
Mr Brown invests £20,000 and he takes regular withdrawals of 5% in order to provide him with an additional income of £1000pa. After 8 months the value of his investment falls to £15,000 and the income also falls to £750pa.

If Mr Brown is relying on receiving the £1000 in order to meet his day to day living costs, the reduction could cause him financial hardship.

Different investment types and their risks

Once you have agreed with your adviser what level of risk you are willing and can afford to take, the next step is to agree where to invest your money. There are various ways to invest money; some of the more common types of investment (known as asset classes) are explained below:

Asset class	Description	Risks	Benefits
Cash	Usually via bank or building society accounts, although you can also hold cash in an ISA (Individual Savings Account) and in National Savings, which often offer fixed term savings accounts at better rates than instant access accounts.	– Inflation risk – Default risk (of deposit taker) – No capital growth potential – Currency risk (if in overseas currency)	– Capital security – Interest paid (mostly variable, but could be fixed in some cases)
Fixed interest securities	Usually in the form of ‘bonds’. Used in this context, a bond is a loan to a company, government or a local authority, and in return you get a regular income from the interest until the loan is repaid. The most common way to invest in bonds is via a fund, (that holds a range of bonds from different companies) rather than holding them directly.	– Interest rate risk – Credit risk – Currency risk (if in overseas currency) – Inflation risk	– Opportunity to earn more than a deposit account and possibly match / beat inflation – Regular income (often fixed) – Loan from each bond is repaid in full at the end of its particular term
Property	Both residential and commercial property is often used for investment purposes – either through direct investment or via a property fund. Investing in property can provide income (rent from a tenant) as well as capital growth (when selling it for a profit in the future).	– Liquidity risk – Market risk – Returns can be volatile – Investment specific / unsystemic risk	– Steady income potential – Long-term capital growth potential
Shares	Also known as “equities” or “stocks”. When you buy shares in a company, you are buying a part of that company, and you become a shareholder. The aim is for the value of your shares to grow over time as the value of the company increases in line with its profitability and growth. In addition, you may also receive a dividend, which is an income paid out of the company’s profits. You can buy shares directly from a stockbroker, or invest via an investment fund (that invests in a wide range of companies).	– Market risk – Currency risk – Investment specific risk / unsystemic risk – Returns can be volatile	– Opportunity for high returns – Inflation-proofing (as shares tend to out-perform inflation over the long-term)

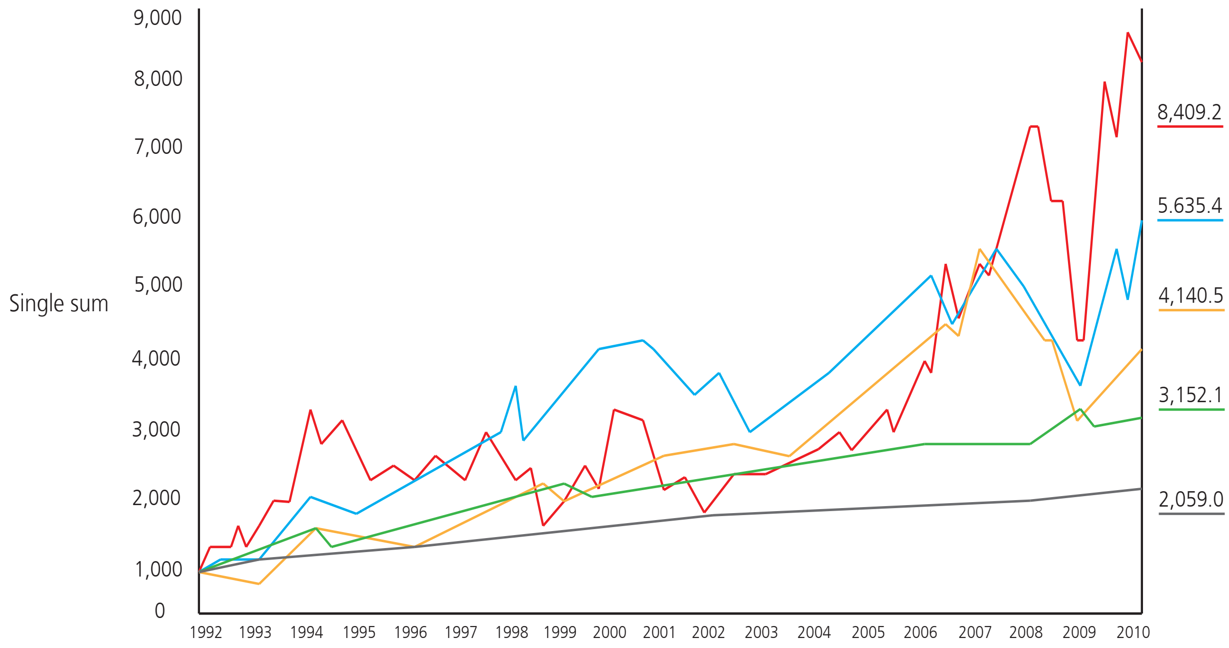


The graph above shows that the returns that can be expected from each asset class can be very varied, but in order to get better returns there has to be a corresponding amount of risk.

Volatility

Volatility can be described as the extent to which the value of an investment varies from the average return over a measurement period. If a fund value varies greatly from the average, the volatility will be high, and conversely a low variation indicates low volatility. Generally speaking you should avoid putting large proportions of your assets in volatile assets unless you are able to leave your investments in place for many years, as there is otherwise a danger that the investment may need to be encashed when returns are low. Shares are the most volatile of the asset classes and their value can vary dramatically over a very short period of time. The graph below shows how the different asset classes generally behaved over the period 1992 to 2010.

Single sum total return, Tax default, In GBP 1,000 invested



20 Years from 31/01/1991 to 31/01/2011

Source: Lipper

Key:

——— = cash funds

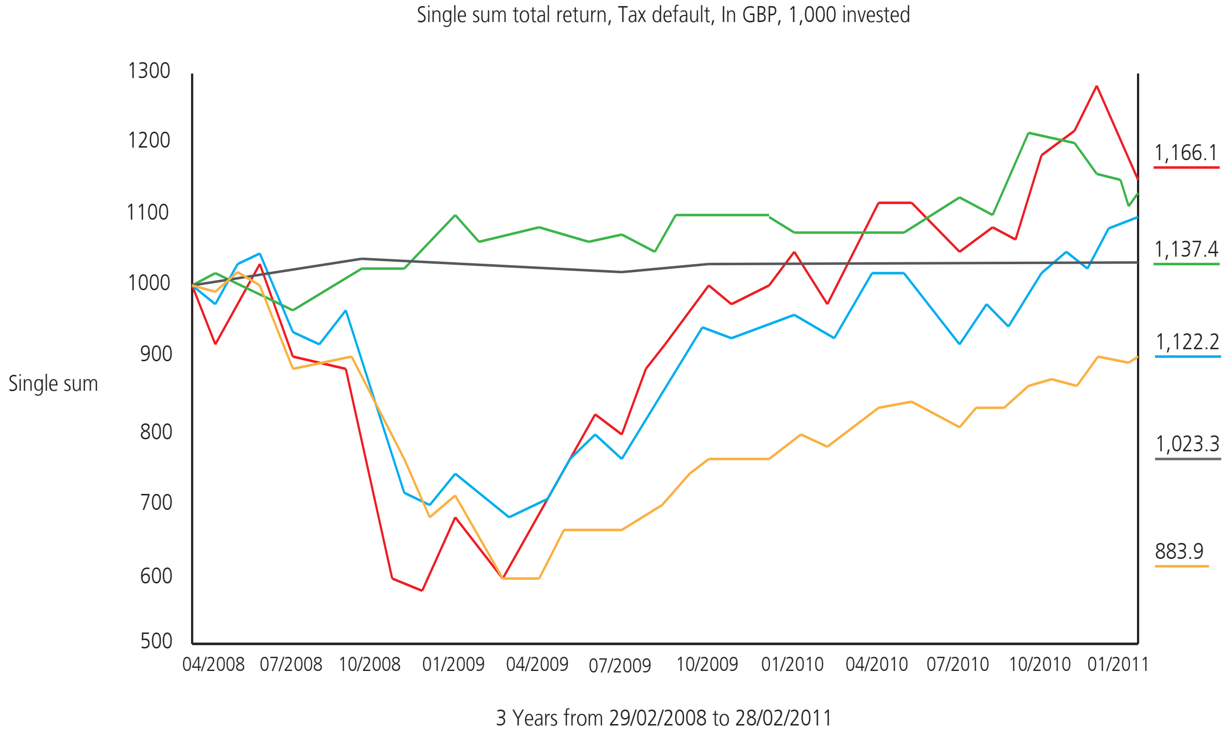
——— = Fixed interest funds (gilts)

——— = Property funds

——— = UK equity funds

——— = Global equity funds

If £1000 was invested in 1992 and was held until 2010, it is clear that an investment in equities would have outperformed property, which in turn outperformed fixed interest and deposit investments. However, equities and property (in particular) have been extremely volatile and there are many periods where an investor would have lost significant amounts of money had they cashed in their investment before the end of the period. So, unless you are able to ride out these peaks and troughs over a long period, and choose when it is favourable to withdraw, placing large proportions of your wealth in volatile funds significantly increases your risk of loss.



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= cash funds

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The graph above shows the same sectors but for a 3 year period only. This illustrates the volatility of equity funds in particular and the need to invest for a long period of time in order to smooth out the peaks and troughs.

Spreading the risk

Not all assets perform equally. Without a crystal ball it is not easy to guess which will provide good returns and which will not. Therefore, the main principle of investing is diversification, which aims to ensure investors have a good spread of investments across the different asset classes, investment sectors and individual companies. By achieving this, poor returns from one individual investment should not have a significant impact on the overall returns.

Peter and James each have £5,000 to invest. Peter decides to invest all his money in Company A and buys 500 shares (worth £10 each). James also invests in Company A, but only buys 100 shares. He splits the remainder of his investment (£4000) equally between companies B, C and D. After 6 months Company A's shares suddenly drop to £5 each and Peter's investment is now only worth £2500. James's investment with Company A has also fallen in value and is now worth £500, however, his investments with Companies B, C and D have all risen in value and are now worth £1200 each. So by diversifying, the drop in share price did not affect James as much as it did Peter and his overall investment is now worth £5300. If Company A was subsequently to fail, Peter would potentially lose all of his investment, whereas James's overall loss would be limited to 20%.

The most common way of achieving this diversification, particularly for less experienced investors, and for those with smaller amounts to invest, is via a ‘fund’ which invests in these assets on your behalf. A managed fund is a professionally managed investment portfolio that individual investors can buy into, purchasing ‘units’ in the fund rather than holding shares directly with companies. The value of your units is calculated on a daily basis and changes as the market value of your assets in the funds rises and falls. Managed funds can have different objectives, for example to provide income or growth; therefore they can be tailored to be more cautious or more adventurous as required. The money you invest is used to buy assets in line with this investment objective.

What happens now?

Having read this guide, you should now hopefully have a basic understanding of risk and how it relates to your investment decisions. In order to determine the correct investment approach for you, your adviser will need to understand your circumstances, your level of investment knowledge, your investment objectives and the level of risk you are prepared to take. Taking everything into account he / she will then recommend a suitable investment solution to meet your needs.