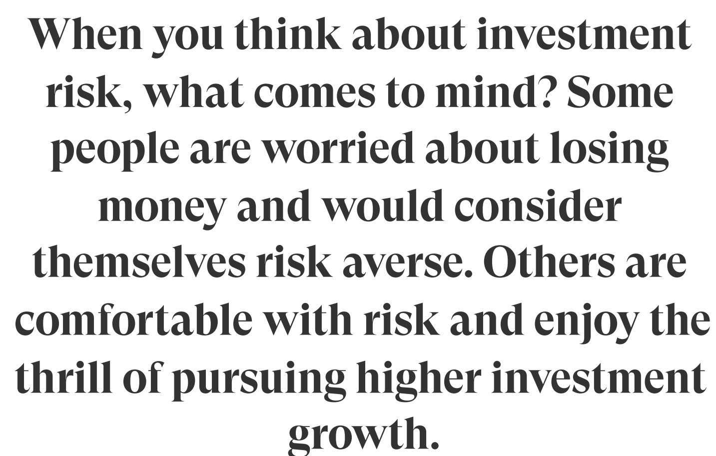
A Short Guide to Investment Risk



When you think about investment risk, what comes to mind? Some people are worried about losing money and would consider themselves risk averse. Others are comfortable with risk and enjoy the thrill of pursuing higher investment growth.

But there are many different types of risk. Determining how much risk to take with your investments is not an all or nothing decision.

So what does risk really mean and how can you manage it within your investment plan?

TYPES OF RISK

Whether you invest in start-up ventures or keep your money in a box under the bed, you are taking a risk. The key is to decide which risks you are comfortable with and manage these as best you can.

The main investment risks are:

- Volatility – the risk that your fund value will go down and that you will lose money. This can be due to factors affecting the entire market or a particular sector.
- Currency – investing in foreign currencies can cause your investments to fluctuate even more as they are dependent on the exchange rate.
- Liquidity – the risk that you might not be able to sell your investments.
- Concentration – the possibility of holding too much money in one place so that you are more exposed if things go wrong.
- Inflation – the risk that your capital may not hold its real value as the cost of living rises.
- Interest rates – fluctuating interest rates have an impact throughout the market.
- Insolvency – the chance that the companies you invest in or hold money with go out of business.
- Timing – the risk of being out of the market and missing out on growth.
- Life expectancy – the possibility of outliving your money if you spend too much or do not take enough risk.
- Changing circumstances – you may need to take money out earlier than planned.

As you can see, the concept of ‘risk’ has many factors that need to be taken into account.

THE DIFFERENT ASSET CLASSES AND THEIR RISKS

Asset classes behave differently depending on what is going on in the market. The main asset classes and the risks involved are explained below:

Equities

Equities, or company shares, are the most susceptible to market volatility. The values rise and fall on a daily basis and the value is not just dependent on the company's performance, but also investor demand.

Established businesses with steady profits are likely to be less volatile than smaller or emerging market companies.

However equities offer the best chance of long-term growth and beating inflation.

Bonds

Bonds are generally a more stable asset class. They are effectively loans to companies or governments, which pay a fixed rate of interest relative to the purchase price.

Bonds are very sensitive to changing interest rates and inflationary pressures. The price can fluctuate according to investor demand, although this is not usually as pronounced as within the equity market.
There is also the risk that the borrower could default on the loan. Bond issuers are given a credit rating which can help to assess how much of a credit risk they present. The greater the risk, the higher the interest rate should be.

Bond performance is not always correlated to equities, which means that the two asset classes can offset each other. Bonds are unlikely to produce the level of long-term growth you would expect from an equity portfolio.

Property
You can invest in property, either directly or through a fund. This asset class tends to fall somewhere between equities and bonds in the risk/reward spectrum.

The main risk with investing in property is liquidity. Selling bricks and mortar can take time and depends on the market. When too many investors request withdrawals at once, many property funds will suspend sales altogether until they can realise some cash. Selling property under pressure can depress values, which has a knock-on effect across the entire market.

Cash
Cash might feel like a safe asset class. But even during normal times, the interest rate on cash is unlikely to keep pace with inflation. This is even more pronounced when interest rates are low and the cost of living is rising. A cash account will have less purchasing power in ten years than it does now.

There is also the risk that the bank could go out of business, although this is very rare. If it does occur, your cash is protected by the Financial Services Compensation Scheme (FSCS) up to the value of £85,000 per bank.

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HOW TO BALANCE RISK AND REWARD

The secret to managing risk is not to avoid it altogether, but to balance the different risks and create a portfolio that aligns with your goals.

Diversification is the key to investing successfully. This means not only holding a combination of different asset classes, but buying a wide variety of assets within each class. For example, a share portfolio should be made up of equities from across the world in a variety of different business sectors.

By holding a wide range of investments, you avoid concentrating too much in one area. All of the different risks, benefits, and timing factors will be smoothed out as the assets complement and offset each other.
It's also important to invest for the long-term. Even a diversified portfolio may lose money in the short-term. Holding your nerve and investing through the ups and downs is likely to yield the best results.

HOW MUCH RISK SHOULD YOU TAKE?

The level of risk you take, and the types of risk you can accept, will depend on three main factors:

- How you feel about risk.
- What you want to achieve and by when.
- How much you can afford to lose without impacting your financial security.

If you are comfortable with risk and have a long investment timeframe, a portfolio containing mostly equities is likely to be most suitable. If you are nervous about investing or plan to retire within the next ten years, a lower equity content with more bonds and cash may be more appropriate. If you are likely to need the money within a couple of years, keeping it in cash will be the best option.

Your circumstances and requirements are likely to change throughout your life, along with your perception of and tolerance for risk. A solid investment plan depends on regular reviews to ensure it continues to meet your requirements.

Please don't hesitate to contact a member of the team to find out more about your investment options.

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