Investment Risk
Balancing investment risk and potential reward

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When constructing your investment portfolio, you need to consider the risks as well as the potential rewards.

This guide helps you understand investment risk and how it can potentially affect your investments.

The key areas it covers include:

- Understanding investment risk.
- Understanding your risk profile.
- Capacity for loss.
- The historical risk-return trade off.
- The importance of setting objectives.
- How professionals manage risk
- General risks
- Understanding asset-related risk
- Our risk descriptions

After reading this guide you will have a greater understanding of the risks associated with different types of investments and be welcome to discuss them with us.

Understanding investment risk

All investments carry some risk, but the level of risk varies depending on which investments you choose. In general terms, the higher the risk, the higher the potential return – and the higher the potential loss. You simply can't build an investment portfolio without considering a number of aspects of investment risk.

More risk for potentially greater reward

Generally speaking, you may need to consider accepting more risk if you want to pursue higher returns. If you decide to seek those potentially higher returns, you face the possibility of greater losses, including some or even all of your investment.

The effect of time on risk

The longer you invest the more time that riskier investments, such as equities, have to recover from any falls. Bear in mind, however, that long-term investing does not guarantee that you will meet your investment objectives.

Understanding your risk profile

Your personal risk profile shows how ready you are to potentially lose money in return for the prospect of rewards. Your profile depends on your attitude to risk and your reason for investing. It also depends on your financial situation and how long you have to invest.

Your attitude to risk

If you have a high risk tolerance you may be more willing to have riskier and more aggressive investments in your portfolio, such as equities or property, in the hope of making potentially higher investment returns.
If you are more cautious, you may want to focus on preserving your original capital as much as possible and prefer more stable, low-risk investments, such as bonds or cash, even though these are likely to offer more modest investment returns.

Your risk profile over time

Your risk tolerance will change over time. At the most basic level, there may be a time to take risks to grow your money; a time to preserve wealth and a time to live off that wealth. Investors in their 20s may not be too worried about a big drop in markets, reasoning they have time to ride it out and profit in a later recovery. Investors in their 50s on the other hand, may focus more on protecting against loss of wealth.

Capacity for loss

This is a relatively new expression that has been brought into use at the behest of the Financial Conduct Authority.

We know about the need to create a contingency fund for emergency expenditure, for instance, the equivalent of six months income to be held in cash to cover unforeseen but arguably probable events, for example a car repair or a boiler breakdown.

Capacity for loss extends this thinking and is in essence examining how your own personal financial situation would or could be affected by a fall in the value of your investments. This is probably best described by providing a couple of examples.

Example 1:

A highly paid 40 year old civil servant with a regular high level of monthly income and low monthly commitments wishes to invest £50,000. Although they would never choose to see their investments fall, if the investments fell by say 70%, arguably this would have little impact on their ability to function on a month to month basis. We could therefore agree with a client in this situation that they had a high capacity for loss. This client can afford to lose money as they have opportunity to recover this situation, time and earnings capacity is on their side. Contrast this with the example on the next page.

Example 2:

A 68 year old widow with only the basic State Pension as available income and has £50,000 total in savings. If this client was to undertake an investment strategy designed to create additional income, we can see that if there was a 70% fall in the investment value, that their savings would be quickly exhausted as a consequence of the fall and the removal of income from the investment. We could therefore agree that this client has a low capacity for loss and any investment strategy would need to accommodate this position. In essence, this client cannot afford to lose money.

Remember to discuss your capacity for loss with your adviser. It can have a significant impact on the type of portfolio recommended. Nobody enjoys seeing their investments fall in value but it would be a dysfunctional market that only ever went up and so when making an investment we need to do so being comfortable that the vagaries of markets does not jeopardise our day to day financial well being and that markets and thus our investments, have time to recover where a fall has occurred.

In summary a high capacity for loss can be summarised as being in a position whereby your everyday financial well being is not affected unduly by a loss in investment values.

Each investor will have a unique risk profile, which is why this needs thoughtful consideration. We can help you determine your risk profile and work with you to develop an investment plan that's right for you.

Equities

Equities, sometimes called stocks or shares, represent ownership in a company. These offer the potential for higher returns, although with higher risk.

Bonds (fixed interest)

A bond is a loan made to the bond's issuer. This could be a company (known as corporate bonds), a government (UK government bonds are also known as gilts), or some other institution. Different types of bonds vary greatly in their risk profile, although government bonds are considered one of the least risky investments.

Property

This can include your own house, as well as pooled funds investing in commercial property offered by an investment management company.

Pooled funds

Pooled funds are professionally managed investment funds which invest in a range of assets.

Cash

Usually includes cash held in bank or building society accounts or pooled funds that invest in short-term cash instruments such as those issued by the UK government.

The historical risk-return trade off

All investments carry some risk, but historically, different investments have demonstrated different risk and return characteristics. In general terms, the higher the risk the higher the potential return and vice versa.

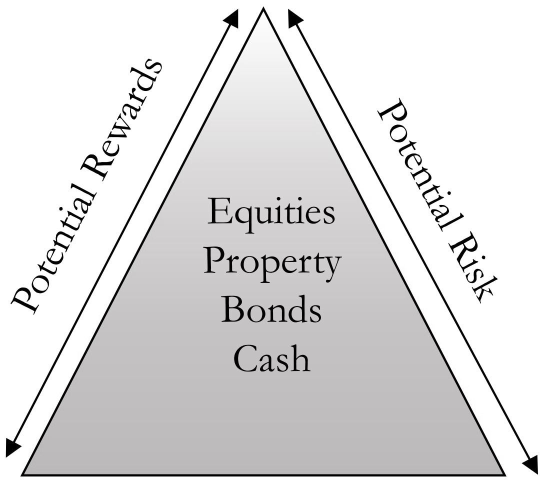
Risk and return over time

Different types of investments, sometimes called assets classes, tend to have different risk/return characteristics over time. The chart on the next slide shows the historical performance of different investments over 20 years. Each type performs differently each year and it's very difficult to predict which will perform well at any given time.

For example, equities have outperformed other asset classes in most years, but have also produced the largest and most frequent negative annual returns.

Based on this historic performance, investment professionals tend to rate the different types of investments according to a risk/return hierarchy, which reflects that if you want greater rewards, you may need to accept greater risk.

The risk/return hierarchy



This diagram is illustrative only and reflects the general way that risk/ reward for the different asset classes is viewed. However, past performance is not a reliable guide of future returns and there are varying degrees of risk within each asset class.

The performance of different investments from 1994–2014

The performance of an index is not the exact representation of any particular investment. As you cannot invest directly into an index, the performance shown in this table does not include the costs of investing in the relevant index. Basis of performance nav to nav with gross income reinvested. Indices used: Equities (MSCI AC WORLD in GBP, Source: Thomson Reuters Datastream), Bonds (Barcap Gl. Agg, hedged in GBP, Source: Barclays), Cash (3M LIBOR, in GBP, Source. Bloomberg), Property (FTSE NAREIT Developed Index, in GBP, Source: Thomson Reuters Datastream)

Past performance is not a reliable indicator of future returns.

The importance of setting objectives

Before deciding on which assets to choose you need to decide why you are investing and how long you have to invest. Balancing the risk you are willing to accept with the investment returns you need in order to meet your investment objectives will help determine which investments to choose.

It is possible to invest using these strategies within various tax wrappers, for instance, an ISA, a Pension or an Investment Bond or collection of Unit Trusts. As part of your overall plan the decision to use these various wrappers will sit apart from the investment strategy. It is of course entirely possible to take a different strategy with different assets, for instance, you may be happy to take a higher risk with a longer term plan such as a Pension, than with an ISA.

Different time frame, different approach

If you are investing for the long term, say for retirement for example, you might choose to hold some equity based assets. On the other hand, if you have to pay for a short term goal such as a wedding, you may decide to hold more cash. Deciding on the basic structure of your investment portfolio is called asset allocation.

Different objectives, different portfolios

Younger investors or those with a higher tolerance for risk might seek a more aggressive investment strategy that holds a higher proportion of equities since they may deliver greater returns over the long term, but at a higher level of risk.

Older investors or those with a lower risk tolerance, who are seeking to preserve capital might want to hold a greater proportion of cash and bonds, which also have the advantage of paying a certain level of income.

How professionals manage risk

You can learn a lot by studying some of the risk Management strategies used by professional investors. Four of the most prominent include diversifying across asset classes, using pooled investment funds, pound cost averaging and adjusting portfolios (sometimes called 'rebalancing').

Diversification

Diversification means spreading your investments across different asset classes and sectors. By not having all your eggs in one basket and by holding investments that tend not to rise and fall together, you can manage the overall risk of your portfolio.

Pooled investment funds

Professionally managed investment funds invest in a range of assets, giving you automatic diversification within a single fund. These funds come in a multitude of types from many different investment management companies. We can help you decide which ones may be appropriate for you.

Pound cost averaging

This refers to building up an investment through regular contributions, rather than investing one lump sum. So, when prices are high, your contribution will buy fewer shares or units – but when prices are low it will buy more. This way, you reduce the risk that you pay too much when the price is unusually high and benefit from buying more shares when the price has fallen.

Adjusting your portfolio

Market fluctuations can affect your mix of assets and change the risk/return profile of your portfolio. Sometimes referred to as 'rebalancing', adjusting your portfolio back in line with your investment objective helps to ensure that your portfolio does not become overly invested in a particular type of investment, and thus change its risk profile so that it's out of line with yours.

These techniques are provided for educational purposes only. We can give you more information about these concepts and how to use them in practice.

General risks

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Investors face many risks.

Some are general and some are related to particular kinds of investments.

Inflation risk

Inflation is like a stealth tax eating away at the value of money. You won't see a smaller cash balance in your account, but you will definitely lose buying power. In other words, the amount that you can purchase with each pound in your pocket slowly erodes over time.

Many savings accounts fail to pay a return that beats inflation, especially after tax is deducted. So even if you reinvest every penny of your interest, the real value of your savings could fall.

Economic and political risk

Economic and political factors play an important role in the performance of investment markets. Economic factors include economic growth, inflation, employment, interest rates and business sentiment. While political risk includes changes in government, political uncertainty and international conflicts.

Shortfall risk

This means the risk of failing to meet your long-term investment target. This could mean that you didn't take on enough risk to get the potentially higher rewards, or that you took on too much risk and your portfolio fell in value.

For example, if you are saving for your retirement, putting all your money into a savings account may not build enough capital to produce the income you will need in retirement. On the other hand, you could also be exposed to shortfall risk if you invest in too many high risk assets causing your portfolio to lose value at the wrong time.

So investing too aggressively or too conservatively can each lead to shortfall risk.

Understanding asset-related risk

Each type of asset has its own associated risks. We can give you more information on how to manage these risks in your portfolio.

Country risk

The risk that domestic events – such as political upheaval, financial troubles, or natural disasters – will weaken a country's financial markets.

Credit (or default) risk

The possibility that a bond issuer will fail to repay interest and capital on time. Funds that invest in bonds are exposed to credit risk.

Currency risk

The risk that changes in currency exchange rates cause the value of an investment to decline.

Interest rate risk

The possibility that the prices of bonds will fall if interest rates rise.

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Liquidity risk

The chance that an investment will be difficult to buy or sell.

Manager risk

The chance that a pooled fund will under-perform due to poor investment decisions.

Market risk

The risk that any market such as equities, bonds, property, or cash, may decline.

Sector risk

The risk that a particular sector within a market, such as the oil and gas sector, or the travel sector, may decline in value. For example, if oil prices surge, the oil and gas sector might rise, but the travel sector might fall due to rising fuel costs.

Specific risk

The risk that a specific share, bond or fund you've invested in performs badly.

Volatility risk

As we saw earlier, different types of investments fluctuate in value over time. This is referred to as volatility and is often used to assess the potential risk associated with an investment.

Risk descriptions for you to choose from

LOWER RISK

People in this category are conservative with their investments. They prefer taking a small amount of risk to achieve modest or relatively stable returns. They accept that there may be some short-term periods of fluctuation in value.

CAUTIOUS

People in this category are relatively cautious with their investments. They want to try to achieve a reasonable return and are prepared to accept some risk in doing so. Typically, these portfolios will exhibit relatively modest yet frequent fluctuations in value.

BALANCED

People in this category are balanced in their attitude towards risk. They don't seek risky investments but don't avoid them either. They are prepared to accept fluctuations in the value of their investment to try and achieve better long-term returns. These portfolios will be subject to frequent and at times significant fluctuations in value.

MEDIUM TO HIGHER RISK

People in this category are relatively comfortable with investment risk. They aim for higher long term returns and understand that this can also mean some sustained periods of poorer performance. They are prepared to accept significant fluctuation in value to try and achieve better long-term returns.

HIGHER RISK

People in this category are very comfortable with investment risk. They aim for high long-term investment returns and do not overly worry about periods of poorer performance in the short to medium term. Ordinarily these portfolios can be subject to the full extent and frequency of stock market fluctuations.

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Performance Line Chart

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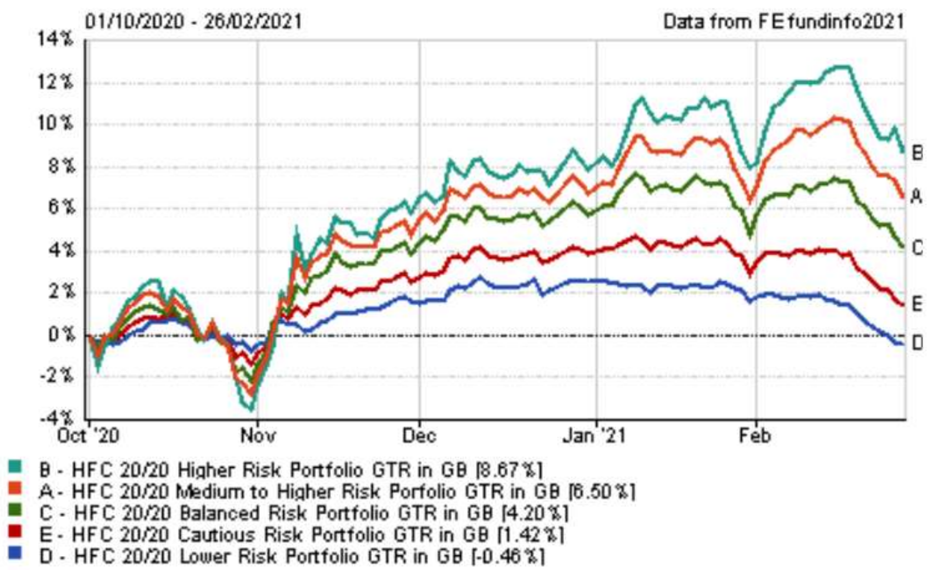
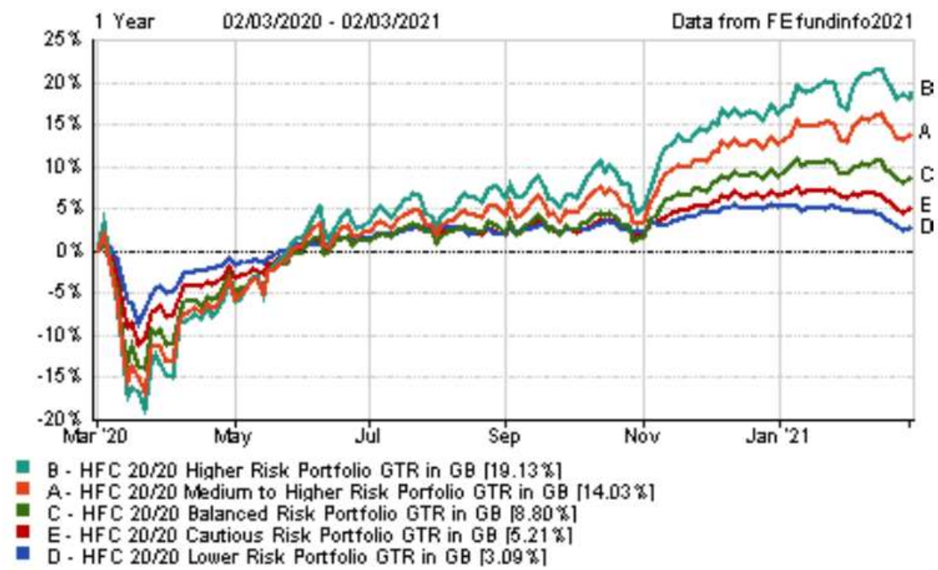
3 March 2021

Pricing Spread: Bid-Bid • **Data Frequency:** Daily





Performance charts for our recommended portfolios

Our services relate to certain investments whose prices are dependent on fluctuations in the financial markets outside our control. Investments and the income from them may go down as well as up and you may get back less than the amount you invested. **Past performance is not a guide to future performance.**

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Performance Line Chart

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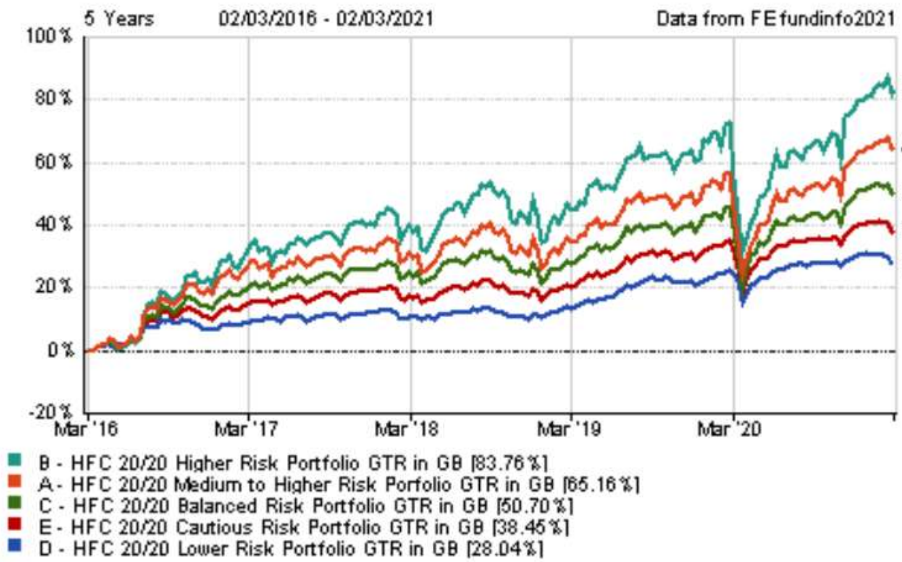

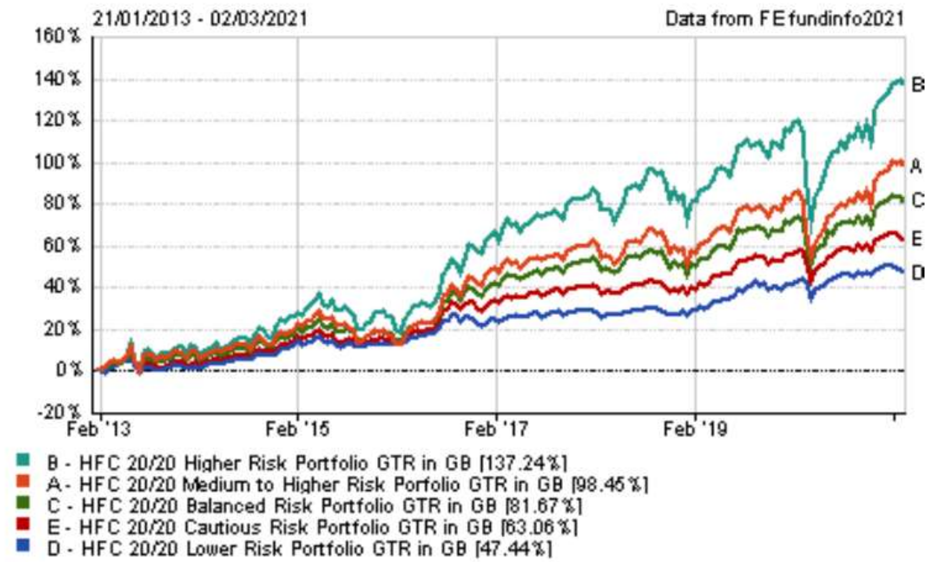

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FE Risk Score Chart

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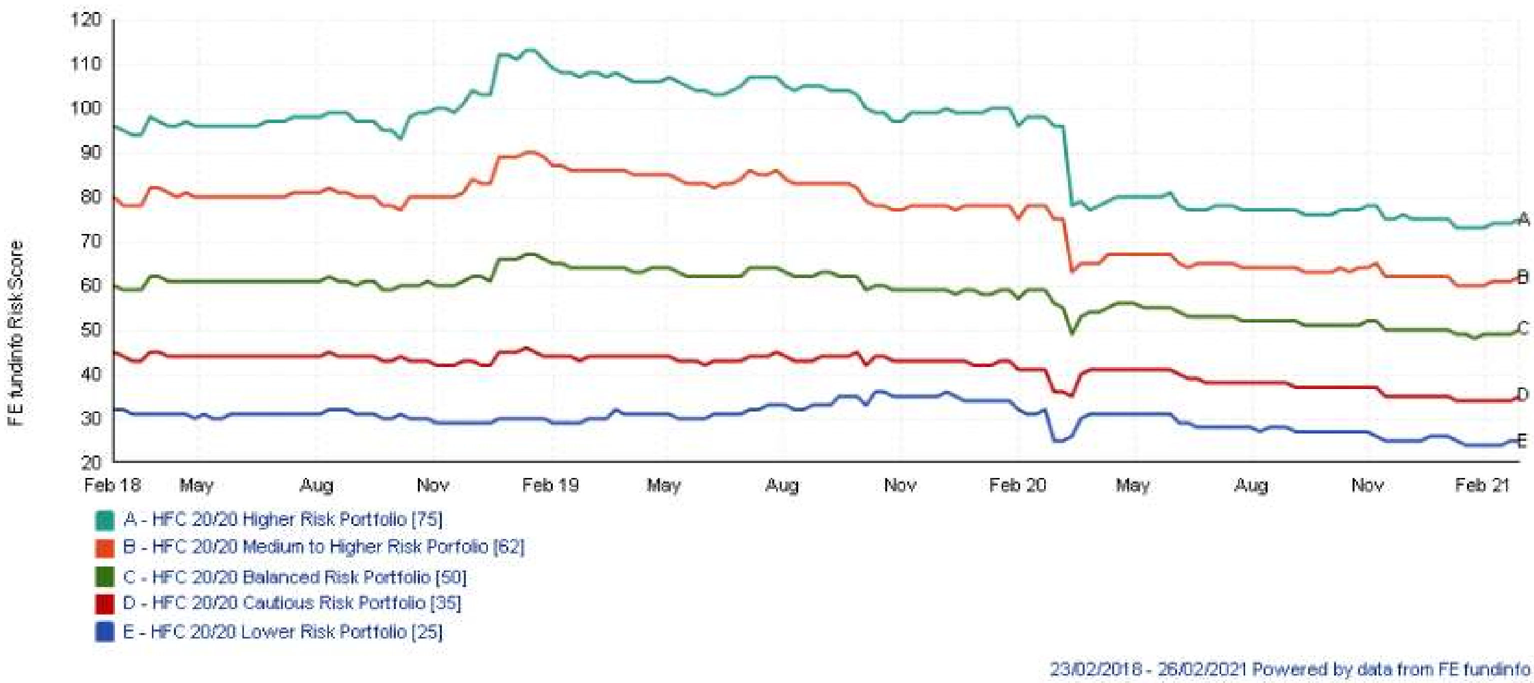

Volatility risk scores for our recommended portfolios

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