KEY ISSUES

Any kind of investing carries some form of risk.

This could be a risk to your capital, or risks related to the unpredictability of markets, inflation & company fortunes.

Your own appetite to risk is a very personal choice and will depend on your objectives, your past experience and your views on investing in general.

A financial adviser can be very helpful in understanding the trade off between risk and reward and making the right decisions for you.

What is risk?

Risk isn't simply the chance you might be defrauded, or that you might not get all your money back. There are other kinds of risk involving uncertainty and unpredictability - such as fluctuations in inflation, interest rates and share prices - which should all be considered when making choices about your investments.

Asset classes and risk - the basics:

There are four main asset classes in which you can invest, with differing levels of risk.

1. **Cash:** the least risky of the four, but tends to produce lower returns - the value of your money can be eroded by inflation.
2. **Bonds:** a riskier option than cash where you effectively lend your money to governments (gilts) or large companies (corporate bonds) in exchange for a fixed rate of interest.
3. **Property:** investing in commercial property such as offices, factories and supermarkets can provide growth from both the rental income and the property value itself.
4. **Equities:** a.k.a. shares are the highest risk asset class, but even within this some markets are more unpredictable than others, UK & US markets are generally less volatile than emerging markets such as China, India & Brazil.

What is capital risk?

Capital risk refers to the possibility that you won't get back **all** of your money (or capital) from an investment. Every investment has some potential for capital risk, but, in the case of cash, the Financial Services Compensation Scheme (FSCS) ensures that, providing you spread your money between banks (with no more than £85,000 held in each bank), you're protected. A general rule is that the higher the return you wish to achieve the higher the risk you must be willing to take. This is because high gains are usually coupled with high volatility—while your capital could grow significantly it could also fall dramatically. So if you're saving for the short-term it's advisable not to put your capital at risk. Over the longer term, you could take more risk as you've longer for your money to make up any losses.

What is inflation risk?

This is the risk that rising prices (inflation) erodes the buying power of your money. While interest rates are below inflation, the savers' returns are not keeping pace with the rising cost of living. As a result of this, keeping all your savings in cash is not a risk-free solution. In fact, if the returns you get don't at least match inflation, you're essentially losing money every year.

EXAMPLE:

Inflation is running at 2% and you pay basic rate tax at 20% on your interest.

Your money would need to be in an account paying 2.5% for the real value of your money to remain the same.

The interest rate must be higher than 2.5% for your money to grow in value.

What is shortfall risk?

Shortfall risk means failing to reach your investment goal because the return you've made on your investments is too low. For example, if you wanted to save £20,000 over 10 years and you can get a return of 3.45% after tax from your savings account. This means you'd have to invest £140 a month to reach your target. If you can only afford to save £100, you'd only be able to make £14,300 over the same period, leaving you nearly £6,000 short.

You may need to invest at least some of your money in an investment which can provide a higher return. One way of managing shortfall risk is to spread your investments across various asset classes.

What is specific investment risk?

This is the risk associated with investing in a particular company's shares. Shares often move in line with the market, or in line with similar companies. But, unforeseen events can have a dramatic impact on the share price for a particular company. For example, BP's share price lost 40% in the aftermath of the Deepwater Horizon oil spill in 2010. Spreading your investment across different companies (diversification) is a good way to protect your investment from such risk. At least if the shares of one company do badly, the overall impact on your portfolio is reduced.

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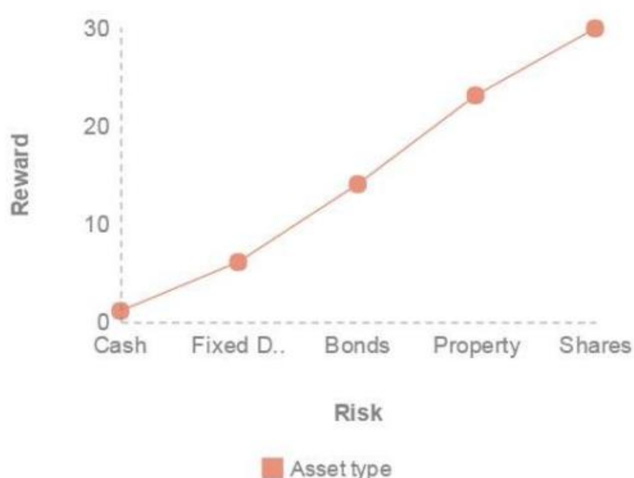
Understanding attitude to risk

Your own attitude to investment risk is critical. While some people are happy to take calculated risks if means the chance of higher returns, others are more cautious and don't want to put their capital at risk under any circumstances, and yet more will be somewhere in between. It isn't straightforward to establish your attitude to risk. Your investment objectives (what you're saving for and when you'll need the money) are a key part of choosing how much risk you're prepared to take. While considering these risks you should bear in mind whether you can afford to lose money, or lock it away for a sustained period.

Risk versus reward trade-off

As we've discussed previously there is a correlation between risk and reward, as higher risk investments like equities (shares) have historically produced higher returns. With this potential for higher returns comes volatility.

This is the trade-off being made when making investment choices, and why spreading investments across a range of higher and lower risk options is often advisable.



Investment risk and financial advice

Helping you to understand where your own appetite for risk lies is a crucial part of a financial adviser's role. There are many ways of doing so and a popular method is with a questionnaire. Aspira's questionnaire provides a range of statements on various topics and asks you to select the one which most closely matches your opinion, and where you're unsure your adviser will be on hand to explain. You'll be asked about a number of key issues, including:

- **Liquidity** - when do you need to take your money out?
- **Rate of return** - what kind of returns would you be comfortable with? What range of potential loss and gain?
- **Inflation** - how important is it to you that your investment keeps pace with inflation?
- **Volatility** - what's the maximum loss you could live with?
- **Investment preference** - what types of investment are you comfortable holding?

Useful links and further information

Much of the information in this document has been taken from the Which? website. A financial adviser will be able to dicuss risk with you in the context of your own goals and circumstances. Please see below some links to useful information:

Which? Money website:

http://www.which.co.uk/money/savings-and-investments/guides/understanding-investment-risk/

Money Advice Service:

https://www.moneyadviceservice.org.uk/en/articles/investing-beginners-guide

MoneySavingExpert:

http://www.moneysavingexpert.com/savings/safe-savings

The value of investments can fall as well as rise, you may not get back what you invested.

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