

Understanding Risk

When it comes to investments, most investors, when asked, usually state they want “maximum returns but little or no risk”. Can this be achieved? And what is risk? Every investor will have a different view of risk and the level or degree he/she may be prepared to accept when making an investment.

Generally speaking, Risk is defined as the amount by which the value of your capital will increase and/or decrease over a period of time. Commonly referred to as **Capital Risk**. This is the possibility that some or all of the money originally invested may be lost. The best example of this is **Stockmarket Risk** – the value of investments linked to the stockmarket varies on a day-to-day if not minute-to-minute basis. And although over the long-term, the trend for investment returns has been positive and continually rising, there have been times over the short-term when stockmarkets have fallen in value, as has happened, perhaps spectacularly, after the events of 9-11 in 2001.

Next to be considered is **Shortfall Risk**. This relates to an individual’s financial objective. This may be saving or investing for a specific reason over a defined time period such as to repay a mortgage or loan, school fees planning or retirement.

Choosing investments with little or no risk will mean returns are likely to be lower and as such could fall short of the proposed target – shortfall risk. The result means having to choose whether to change the target amount, increase the amount saved or invested, increase the time period over which savings or investments are made or accept the shortfall and adjust accordingly.

Shortfall risk is therefore linked closely to **Interest Rate Risk**. On the one hand falling variable interest rates are bad for savers, but on the other, are good for borrowers. Depending on the financial objective, prevailing rates at the time of investment and the economic outlook (as far as it can be predicted), it may be appropriate to consider fixed rates; however when interest rates rise, fixed rates are bad for savers and good for borrowers but when the variable rate falls the converse is true.

Similarly, **Inflation Risk** can be both good and bad, depending on your financial objective. In the main, inflation risk is detrimental as, over time, rising prices reduce the buying power of capital or income available. To reduce the effects of inflation risk usually means increasing the degree of capital risk. The effects of this are illustrated in Table 1.

And what about **Timing Risk**? Should one wait for the stockmarkets to fall before investing, although this could be several years in the future, and the opportunity for growth is missed? Is a single investment best or a series of investments?

Whatever the decision, much will also depend on an individual’s age and the time span over which an investment is to be made. Family commitments may also have an impact on the level of risk that is acceptable.

Table 1:

The effect of Inflation on £1000 (ie the real or spending value at predetermined rates of inflation)

Period	3%	5%	7%
5 years	£863	£784	£713
10 years	£744	£614	£508
15 years	£642	£481	£362
20 years	£554	£377	£258

The table clearly shows that even at low levels inflation can affect the value of capital over time so leaving all your capital on deposit is not really a viable choice. It is important therefore not to ignore the impact inflation can have and the need to ensure capital growth is in excess of inflation.

Table 2 on the following page identifies the perceived level of risk associated with the various types of investment available although some funds within certain sectors will have a different perceived level of risk to their respective peer funds. It is possible for example to have a fixed interest fund that could be high risk or an international fund with a medium risk profile.

Table 2:

Investment	Description	Level of risk
Cash	Bank & building society accounts offer a high degree of capital security because their value does not fluctuate, however the level of interest may well do	Very Low
Fixed Interest Funds	Fixed interest securities tend to show smaller price fluctuations than shares. However, both the capital value and the income can vary.	Low
Pooled Funds – UK Larger Co's	Equities or shares fluctuate in price more than bonds but offer greater potential growth over the long term. Funds providing income often invest in larger, established "Blue Chip" companies	Medium
Pooled Funds – UK Smaller Co's	Investments in smaller companies will tend to fluctuate in value more so than their larger counterparts. The more aggressive growth funds tend to invest in these small to medium companies.	Medium to High
Direct Equities	Direct investment in stocks and shares will fluctuate in value to a greater degree than pooled funds because of the reduced level of diversification.	High
Pooled Funds – International	These funds hold assets that are denominated in foreign currencies. They will therefore be affected by fluctuations in currency exchange in addition to the usual stock market fluctuations.	High
Pooled Funds – Emerging Markets	The markets in which the funds invest are generally less well regulated and may be more difficult to trade in other more developed overseas markets.	Very High