Atkins Bland

Investments • Pensions • Financial Planning

Guide to: Investment Risk

Introduction to Investment Risk

“Risk” is an emotive word, often representing danger and peril. That may not be strictly applicable to the risks associated with investment, but it isn’t entirely wrong either:

- If you take investment risks beyond your capacity to cope with the possible consequences, you can put your financial security, and that of your family in danger, the implications of which can be daunting.

- On the other hand, if you avoid all investment risk you can land up in the same mess, with inadequate resources accumulated and insufficient income to live on when your working life has finished.

Investment risk is, therefore, a topic to be taken very seriously, as getting your approach to it right can make a massive difference to you, as can getting the approach wrong.

Defining investment risk

Investment risk can come in many guises, some obvious and some not so. However, in its simplest form, it is the risk of losing the capital you have, or the income it can generate, or both.

It can also, though, be the risk of losing the benefit your capital could have given you if invested differently, which may be a more elusive definition, but could prove just as important in terms of eventual outcomes.

Why accept investment risk?

To seek a better reward.

The return you get on investing capital is normally in exchange for:

- lending it to a financial institution which pays interest to borrow it (e.g., placing it on deposit)
- buying something that can generate an income, such as shares or property
- buying something you hope to sell later for a profit.

All these actions can involve some risk to the capital, the degree of which varies considerably but, in normal conditions, the more the risk you take, the higher the potential return.

Introduction to Investment Risk

What causes investment risk?

Risk has many constituent parts, but here are some of the most important points to focus on:

Risk and reward

There is a relationship between the two. If the potential reward was the same, almost everyone would select the option with the lowest risk.

This creates the ‘risk/reward dilemma’, where opposing motives clash. In one corner is risk aversion, in the other the desire for a decent return.

Do you prefer zero risk and very limited return or high risk and potentially high return or, like most of us, something between these extremes?

An investment adviser will help you make a rational decision on this pivotal issue, by looking at your circumstances, considering your needs and discussion your priorities and preferences.

Understanding who you are and how you feel is just as important as understanding your financial position.

Risk and time

Again, there is a direct relationship between these two. An investment that is quite high risk over a very short term might be a lot less risky if held for a longer period.

This is because, if your investments take a tumble in value for one reason or another, a short time frame gives less potential for a recovery to come along.

Risk and investor discretion

If you can choose when to sell investments based on relevant market conditions and wait if needed, the risk of loss is much less than it is if such flexibility is absent. This discretion can be created by holding enough in cash deposits to fund shorter term spending needs.

However, there are situations where discretion cannot be achieved that way, such as a planned retirement date and an intention to use your pension fund buy an annuity or the expiry date of an interest only mortgage, which will need to be repaid on or before that date.

Risk and investor behaviour

Investor behaviour has a big impact on investment risk.

If you invest in something where the value fluctuates, you must be prepared for the fact that values will sometimes fall, possibly dramatically.

If you will not panic when they do but stay invested to allow a recovery to come along, the risks caused by short term volatility are greatly reduced.

However, if you might panic and sell after markets have fallen, that creates a lot of risk of experiencing a real loss.

Only those willing and able to ride through a crisis and await a recovery should invest in assets where values might fall.

Introduction to Investment Risk

Risk and market conditions

Risk is greatly influenced by market conditions. Something out of favour may have already fallen in value, so the risk of a further fall is reduced. Something in favour may already have risen strongly, so the risk of a setback is increased.

It is easy to forget this and be tempted to invest in the things which have done best in the last year or two and avoid those which have done badly, but that can often add a lot of risk.

Just because one area of investment has been the strongest performer in the past, doesn't mean it will continue to be in the future. In fact, a strong run can often take values too high, leading to a weak patch while this is corrected.

Risk and the economic climate

Investment risks can shift quite considerably over time as global or local economic conditions change.

Risk is not a stable thing, but dynamic. This means it is important to keep everything under review. Our *Guide to the Risks of Static Risk Classifications* has more on this important issue.

Deconstructing investment risk

Some of the main risks you might face when investing capital

Losing your capital completely

This can happen if you invest in the shares or bonds of a single company, which subsequently goes bankrupt.

The risk can be reduced or increased depending on the nature of the company. However, even huge household name companies occasionally fail, with a total loss for their shareholders.

Complete loss can also arise because of gearing (borrowing). For example, if you buy a property to rent out for £200,000 and have a £20,000 deposit and fund the rest with a £180,000 mortgage, a 10% fall in the property value, from £200,000 to £180,000, could cause full loss of the money you invested, if you had to sell at that time.

If an investment can cause the complete loss of your capital, it must be classified as quite high risk, however sound it may appear. The risk of complete capital loss may be remote, but the extent of the possible loss needs to be remembered.

This risk can be mitigated by diversification, such as is achieved by collective investment funds or, in the case of gearing, avoidance or limitation of exposure.

The value falling

This is a far more common situation. It can arise with most investments other than cash deposits or guaranteed products. Most assets will fall and rise in value as part of the normal pattern of their markets.

The scale of a potential fall varies from one asset type to another, between investments within the same broad asset type and with the passage of time.

In the vast majority of cases, if an investment falls in value but does not become completely worthless, the value will eventually recover, although this is not always the case.

This means that, for a patient investor, a fall in value will often not cause any loss, as they will not sell but still hold the investment when its value recovers.

However, nothing is ever guaranteed and anyone unprepared to accept some uncertainty over what they will get back when they eventually sell their investment should not invest in something where values can fall.

Deconstructing investment risk

Some of the main risks you might face when investing capital

Loss of purchasing power

When prices rise due to inflation, the real value of money falls.

Many investments offer the potential for your capital, and the income it produces, to rise to combat inflation but those which do not will carry a risk of loss created by inflation.

Some investments involve a certainty of a loss of real value unless there is no inflation. A deposit account with interest withdrawn as income is the most common example of this.

Failure to consider the risks caused by inflation can have a very damaging impact of your financial security, especially over the longer term.

Failing to achieve what you need from your savings

Often overlooked, this can be a bigger risk than any of the others in terms of damaging your financial security.

A common example is failing to achieve enough real growth on a pension fund or other investment earmarked for retirement.

If you land up without enough to generate the income you need, you may be forced to spend the capital itself. In turn, that runs a risk of the money running out and a truly miserable time in later retirement.

Event risks

There are plenty of unpredictable events which can derail even the best constructed investment planning, such as poor health forcing you to spend resources earmarked for retirement much earlier than expected, and possibly seeing these dwindle away to nothing.

You can usually cover many event risks through insurance and failure to do this can be a high-risk strategy, given the potentially catastrophic consequences.

Classifying investment risk

How we describe the six broad risk categories we use

Risk category	Description	The benchmarks we use to compare results	
		Investment association	ARC Private Client Indices
Zero	No risk to capital values Low income No potential capital growth High risk from inflation	NA	NA
Low	Very modest risk to capital values Low income Very modest potential for capital growth Fairly high risk from inflation	IA Sector Mixed Investment (0-35% Shares)	ARC Sterling Cautious PCI TR
Below average	Modest risk to capital values Relatively high income Modest potential for capital growth Fair potential to combat inflation	IA Sector Mixed Investment (0-35% Shares)	ARC Sterling Cautious PCI TR
Average	Larger but not excessive risk to capital values High income Good potential for capital growth Good prospect of combating inflation	IA Sector Mixed Investment (20-60% Shares)	ARC Sterling Balanced Managed Asset PCI TR
Above average	Larger risk to capital values High income Potentially enhanced capital growth Good prospect of beating inflation	IA Sector Mixed Investment (40-85% Shares)	ARC Sterling Steady Growth PCI TR*
High	High risk to capital values Not well suited to income generation Potentially high growth Very good prospect of beating inflation	50% IA Sector Global and 50% IA Sector Global Emerging Markets	ARC Sterling Equity Risk PCI TR

** Please note that we consider the ARC title "Steady Growth" is misleading. This is an above average risk portfolio strategy so is expected to experience a bumpy ride, rather than the smooth and steady progress implied by the title.*

A word about the benchmarks

We use two benchmarks rather than just one.

The first is based on the average performance from multi asset collective investment funds and the second the average performance from a wide range of the largest private client portfolio managers.

The IA sectors impose strict parameters on the level of equity exposure allowed for a fund to stay in its allocated category. While we use these traditional benchmarks, we do not attempt to, or wish to, apply the restrictions they are under so we adopt a less constrained approach.
This means our asset allocations may differ significantly from the construction of the relevant IA benchmark. In particular, we may have exposure to shares which is higher than the top of the benchmark range or lower than the bottom of the range.

The ARC sectors allow much wider discretion to the managers than the IA sectors. This is more in line with our own strategy, so we feel including these as well is helpful to our clients in terms of assessing the comparative performance of our asset allocation advice.

For more information on this and the general subject of our approach to benchmarks, our *Guide to Atkins Bland's Use of Benchmarks* is available on request.

Risks associated with investments

Risks associated with individual investments

Table A, below, shows what we estimate as the maximum potential loss over 1 and 5 years from an ***individual*** investment in each of the broad risk categories we use.

Table A:

Our risk classification	**Estimated maximum potential loss over a 12-month OR 5-year period**	
	Percentage	Example based on £10,000 invested
Very low	Nil	Nil
Low	15%	£1,500
Below average	25%	£2,500
Average	40%	£4,000
Above average	75%	£7,500
High	100%	£10,000

To explain the above, our estimated maximum loss for a single investment over a 5-year period is the same as over a 12-month period. This is because we feel that, over a 5-year period, it is very unlikely the overall result could be worse than in a single year during a market crisis.

Please note it is always possible for an investment to fall in value by a larger percentage than the figures we show.

Risks associated with a portfolio of investments

Table B, below, shows the same data but based on a diversified portfolio in each risk classification, rather than a single investment, and also showing estimates based on 10 years.

With a portfolio, the overall risk strategy is achieved through a mixture of investments in different risk categories and geographic and industry sectors, thereby creating a very wide level of diversification and reducing overall expected volatility.

Table B:

Our risk classification	**Estimated maximum potential loss over 12 months Example based on £100,000 portfolio**	**Estimated maximum potential loss over 5 years Example based on £100,000 portfolio**	**Estimated maximum potential loss over 10 years Example based on £100,000 portfolio**
Very low	Nil	Nil	Nil
Low	10% or £10,000	5% or £5,000	Nil
Below average	20% or £20,000	15% or £15,000	Nil
Average	30% or £30,000	20% or £20,000	5% or £5,000
Above average	40% or £40,000	30% or £30,000	10% or £10,000
High	60% or £60,000	50% or £50,000	15% or £15,000

Risks associated with investments

As you will see, we believe the risk of loss reduces as time period expands. This is because investment markets are more vulnerable to the impact from extreme events or bad news over short periods, when short term speculators can dominate market movements, than they are over the longer term, when the ups and downs tend to be evened out.

Over 10 years, an overall loss seems extremely unlikely based on past records, but it is still possible, especially further up the risk ladder, so we have entered figures to illustrate this, despite the historic records.

The estimated losses could be higher if the portfolio were less diversified than average, for instance with a smaller portfolio.

Please note it is always possible for a portfolio to fall or rise in value by a larger percentage than the figures we show.

Potential gains

The risk of loss and your willingness and ability to accept it should be the main driver behind your investment risk strategy. However, it can still be helpful to consider how much extra gain you could enjoy if you accept more risk.

The reality is that no one can possibly know this in advance. However, the figures in Table C below, show our opinion of a realistic expectation of average yearly total returns over a period of 5 year or longer.

Our estimates are based on total returns (income as well as possible capital growth) on a yearly basis from a portfolio in our different risk classifications and do not take account of inflation.

The suggested total returns below are **before** portfolio administration and advice costs, but after internal fund management costs.

Table C:

Risk category	Likely range of annualised returns
Low risk	0% to 2.5% yearly
Below average risk	2% to 4% yearly
Average risk	3% to 5% yearly
Above average risk	3% to 6% yearly
High risk	2% to 7% yearly

These figures are **before** adjustment for inflation and are **annualised**, which means they are an average of what an investment portfolio may earn over a period of time.

When we are projecting future values in today’s terms, so after adjusting for inflation, we generally assume the total return from a suitably invested portfolio matches inflation but achieves nothing more than that.

We emphasise that this is much less likely to be achieved from a low-risk strategy, while the potential to achieve or exceed this over the medium to long term increases as you move up the risk ladder.

More information on how we approach this important topic will be found in following guides, available on request.

- *Atkins Bland Guide to Our Assumptions for Future Investment Values*
- *Atkins Bland Guide to Forecasting Future Retirement Income*

Volatility in pictures

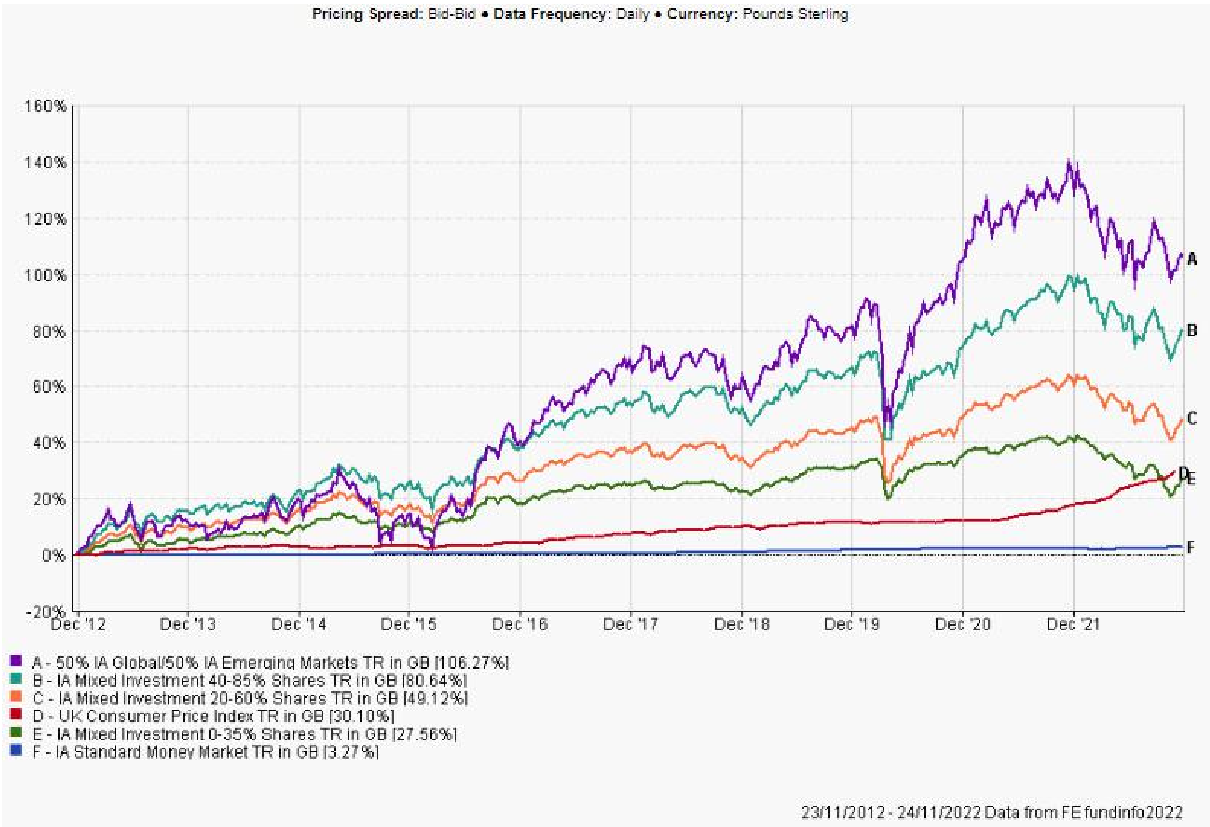
The past is definitely not an accurate guide to the future. However, the graphs below are still helpful in showing the actual past behaviour of the risk graded benchmarks we use. **We have used the IA benchmarks for this, but the same general pattern applies with the ARC benchmarks.**

As a reminder, the risk categories they represent are:

Low risk	IA Standard Money Market
Below average risk	IA Mixed Investment 0-35% Shares
Average risk	IA Mixed Investment 20-60% Shares
Above average risk	IA Mixed Investment 40-85% Shares
High risk	50% IA Global and 50% Emerging Markets

We have also included the UK Consumer Prices Index as a representation of inflation, as this is helpful to consider.

Cumulative 10-year total return to November 2022 (in GBP)



Volatility in pictures

And how this breaks down by discrete year results

Index	2022	2021	2020	2019	2018	2017	2016	2015	2014	2013	2012
50% IA Global/50% IA EM	-11.4	9.6	14.5	19.2	-8.6	18.8	26.7	-3.4	5.2	7.7	11.3
IA Mixed Inv 40-85% Shs	-8.9	10.9	5.3	15.8	-6.1	10.0	12.9	2.7	4.9	14.5	10.0
IA Mixed Inv 20-60% Shs	-8.7	7.2	3.5	11.8	-5.1	7.2	10.3	1.2	4.9	8.9	8.4
IA Mixed Inv 0-35% Shs	-9.9	2.8	3.9	8.7	-3.4	4.8	8.5	0.4	4.8	4.2	6.2
IA Std Money Market	1.0	-0.1	0.4	0.7	0.5	0.1	0.2	0.1	0.1	0.2	0.6
UK CPI	9.6	5.4	0.7	1.3	2.1	2.9	1.6	0.2	0.5	2.1	2.6

Note: Discrete annual total returns in GBP. Source: FE Analytics

Cumulative 20-year total return to November 2022, to November 2022 (in GBP)

These tables and charts demonstrate the obvious fact that short term volatility naturally tends to increase as you move up the risk ladder, but so does long term performance.

Further considerations

Does volatility matter?

Only when you are buying or selling.

At any other time, it should make no real difference to you, unless you let it.

If volatility influences your decisions, such as leading you to sell in a panic after markets have fallen and the media is scaring the pants off everybody, then volatility certainly does matter.

If you are investing for the longer term and prepared to sit tight through the inevitable bad patches, then short-term volatility in capital values should not be a problem.

However, it is important to invest in assets where such volatility should remain within your comfort zone, otherwise the stress of a sharp fall might overcome your resolve and force a decision to sell, thereby missing the recovery and creating a loss you could have avoided.

Some guidance on core points to consider

When selecting your risk strategy, give careful thought to the following questions:

- How long can my money be invested before I'll need it for expenditure
- Do I have enough on deposit or through insurance cover to cope with emergencies
- Will I be patient during a crisis, or might I panic and sell after values have fallen?

Keep your answers to these questions under review as a change to any of them could imply you should adjust your investment risk strategy.

Always be aware that your personal capacity for risk may alter, perhaps because of a shift in your circumstances.

If you do need to adjust your risk strategy, you should do so at a sensible time, not during an investment market crisis.

Try to plan your money to make sure your short-term needs are covered. Keep some cash on easy access deposit and take out insurance if your financial security or that of your family is at risk if you suffer a health problem or pass away. If you do this, you or your family should always have a choice over the timing of the sale of your investments.

Further considerations

Getting your investment risk strategy right

For some people the right strategy is simply what suits their preferences, as their circumstances are such that they are safe with no risk, high risk, or anything in between.

For these lucky souls, it's all about working out personal priorities and what makes them feel good.

However, for most of us it's more complex than that, as we do need our capital to achieve something, be it security now or resources for later or a mixture of both.

For many, the low return associated with very low risk investments means they are unsuited to their primary objectives and longer terms needs.

For others, their financial position is too precarious and uncertain to tolerate a risk of their capital falling, even if that means they must put up with a very low return.

The degree of investment risk you are comfortable with, and can tolerate, will depend on your specific circumstances and priorities.

Your Atkins Bland adviser will discuss all of this with you and help you assess what is best for you.

How do we help you assess what's best for you?

There are two core issues to consider. One is your *capacity* to accept risk, and the other your *willingness* to.

Capacity to accept investment risk

This can be influenced by a wide range of factors, and these can differ substantially between one person and another. However, it is a measure of someone's ability to cope with the consequences of their capital, or the income it generates, falling in value.

Atkins Bland will assess all relevant factors to ensure that the agreed risk strategy fits comfortably with your personal capacity for risk.

Further considerations

Willingness to accept investment risk

For most people (but by no means all) this will be influenced strongly by their capacity to accept risk. However, within any given capacity to accept risk there can be a significant difference between one person and another in terms of their willingness to do so.

This is because we have different priorities and preferences. Some are by nature extremely cautious while others are quite happy to take a high level of risk. Most people fall somewhere in between these two ends of the spectrum.

To help us assess your own willingness to accept investment risk and to understand your likely behaviours and decision making in different situations, we use a Risk Profiling Questionnaire (RPQ).

The questions are carefully thought out and your answers will be a helpful guide, but this is only part of the process.

There will nearly always be some answers which suggest a different risk category than the majority do, which is natural. After all, we are dealing with a dilemma between conflicting motivators.

When we assess your replies on our RPQ we will flag any of these that we feel suggest a need for discussion. After we have looked at those, we can let you know our thoughts on what seems best suited to you, and you can then let us know if you agree or not.

Following that, a decision can be reached.

Whatever that decision is, the process we have been through should ensure it is right for you, both in terms of your personal preferences and in terms of allowing your capital every prospect of doing what it needs to.

Glossary of terms used

Below is a brief glossary of the financial terms we've used in this guide:

Term	Description
Collective Investment Funds	These are funds where investors' money is pooled together to enable the fund manager to create a widely spread portfolio. You are not exposed to the fortunes of a single company.
Guaranteed products	Investments which provide a guarantee to return the amount invested under defined circumstances.
Equities	Shares in companies.
Bonds and Fixed Income Securities	Loans to companies (also known as "corporate bonds") or the Government (known as Gilts in the UK) paying interest over a set period and which can be bought and sold during that period.
Inflation	The erosion of the real purchasing power of capital over time due to increasing prices.
Diversification	Investing in a spread of different investments, markets or types of assets in order to reduce the overall risk.
Portfolio	A structured collection of different investments to produce an overall investment strategy.
Volatility	The extent to which an investment moves up and down in value over a period.

Important notes

Any opinions expressed on the merits or disadvantages of any options are intended as a general comment only and not as specific advice to the reader.

This document is intended as a supplement to full independent advice and not as a replacement for it and should be read in conjunction with any personalised recommendations provided by Atkins Bland Ltd and with any product brochures supplied.

The value of investments will fall as well as rise, as can any income produced.

Inflation can reduce the real value of capital and the income it generates.

Past investment performance is not a reliable guide to the future.

Any reference to taxation, regulation or legislation is based on our current understanding and details should be checked before any reliance is placed upon its accuracy.

The impact of taxation and tax planning depends on individual circumstances and may be subject to change, which can be retrospective.

Errors and omission excepted.

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The value of investments will fall as well as rise, as can any income generated. An investor may, therefore, get back less than invested.