AN INTRODUCTION TO RISK PROFILES

An essential part of being able to provide ongoing investment advice is for us to understand your risk profile. By this we mean to determine your aversion to taking risks with the capital value of your investments. These notes are designed to dovetail with our further notes on asset allocation and our asset allocation report.

Within this note we will cover:

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1. WHAT IS RISK?

We have separate notes to explain what risk is and why you need to take risk to achieve your objectives. Search our website for:

- What Is Risk And How Much Do You Need To Take?

2. THE RISK QUESTIONNAIRE

The conventional way of assessing a client's ability to accept greater volatility in exchange for higher rewards is a questionnaire. There are some excellent questionnaire's around, we currently use the EValue Questionnaire from Financial Express Analytics.

Whilst these questionnaires are very good they cannot allow for the nuances of each investor so for instance The EValue questionnaire asks you how adventurous you are with regard to investing? For some clients adventurous would mean high risk off exchange companies, for others it would mean buying a FTSE 100 collective.

3. SCORING THE RISK QUESTIONNAIRE

At its simplest the risk score should define what percentage of your assets and investments are in "Growth" funds as opposed to "safe" funds.

Traditionally growth funds are defined as "funds which are not cash or fixed interest". In our view it is now safer to define "Safe" assets. Right now the only secure assets are National Savings & Investments (NS&I), cash accounts and premium bonds.

Within the Growth funds alternative there is a huge range of risk. A single Off Exchange or Alternative Investment Market (AIM) share investment is hugely risky and could well cause you to lose ***all of*** your investment. A global equity index will carry equity risk but virtually no stock risk and is highly ***unlikely*** to lose all your money.

4. WHAT DO WE USE THE RISK PROFILE FOR?

At it's simplest the risk number from your questionnaire will define which of a standard set of investments you are offered. The lower your score the higher the amount of fixed interest funds you will be invested in.

Most discretionary fund managers (SFM) use your score in isolation. Our approach varies according to your service level.

4.1 Wealth Management Service

If you are on our Wealth Management service we will usually include all your cash and investments (including let property) in our assessment. The only asset we usually exclude is your home.

4.2 Portfolio Management Service

Here there isn't the fee to pay for an in depth valuation of all assets however we will include an allowance for assets we don't manage based on the client's valuation.

4.3 Guaranteed Income

If you are retired we believe we should include the capital equivalent value of your guaranteed pensions as part of your Safe funds. Since the purpose of investments is ultimately to provide income when you are unable to work.

We assume pensions are secure investments (UK pensions are guaranteed up to 90%). Therefore, if your state pension is £10,000 pa and the rate of amortisation for an indexed linked pension is 2.5% then for investment purposes you have a low risk asset equivalent to £400,000. This then makes a huge difference to how much free capital can reasonably be invested into longer term assets.

5. RISK IS SUBJECTIVE ACCORDING TO YOUR KNOWLEDGE AND EXPERIENCE

Every risk profiling engine is geared to creating a guide for the "average" investor. This would normally be someone who has little or no knowledge of investments and hence a lack of knowledge leads to greater caution.

An experienced investor will look at normal equities as low risk and AIM and Off Exchange investments as higher risk. Many clients consider residential property as low risk because we have all owned property and seen it rise over many years.

From a risk perspective normal equities are not low risk (due to stock risk) and residential property is certainly not low risk, particularly if the asset has a mortgage and so is geared. Let property is high risk as you have a single asset and are subject to the vagaries of your tenant.

Experience breeds complacency and the converse, the unknown breeds caution, very much applies. We consider our job is to guide you regarding investments so you can make an informed decision and when the inevitable crash occurs, you are ready for it.

We have investors who have a risk profile score putting them in the cautious camp who end up investing in the upper end of a balanced portfolio. It all depends how comfortable you are with the typical investments we recommend.

A good "rule of thumb is to increase your Risk score by say 10 points if you:

- Have run a business.
- Have bought equities speculatively (not privatisations)
- Have had significant employee share schemes.
- Have used higher risk investments to defer / save tax.
- Have bought property to let.
- Have bought investments using loan finance (excluding your home).
- Have bought significant crypto currency.

The above list isn't comprehensive but it gives an idea of the level of the questionnaires. Clearly if you have done more than one if the above you should consider increasing your score still further.

6. OBJECTIVE RISK

The objective risk is that you may not achieve your objectives if you do not take enough risk. For instance, your risk score may say you should invest in cash and low risk investments. Cash will (net of tax) never keep up with prices (inflation). To achieve your objectives you may need your capital to grow in real terms so you either have to lower your objectives, save much more or take more risk than you would prefer.

7. THE RISK PROFILES WE USE

It is generally accepted that in order to obtain higher returns it is necessary to accept greater risk. Conversely, savings with little or no risk to their capital value will provide lower returns but are less likely to fall in value in the short term.

The following are examples of suitable investments for each of the Financial Express 6 risk profiles. Remember that the investments we have suggested here assume a novice investor. An experienced investor may have the same risk profile result but would have a completely different range of investments.

7.1 No Market Risk (score 1)

Anyone who cannot cope with any market risk should be entirely in Cash and National Savings.

7.2 Cautious (score 2 to 31)

Cautious investors want to see little reduction in the value of their investments. These clients should most of their money in consider cash and National Savings. As they go up the scale then they can consider some fixed interest and lower risk equities.

Typically a "Cautious" investor has between 1% and 36% of their investments in asset backed investments. Based on the Dimensional 20 years back tested data this risk level might generate annual overall returns of between -5% and 10% with an average return of between 0% and 1.5% before costs.

Secure investments would be defined as investments where there is virtually no risk to capital. The returns from these investments are predictable and would include investments such as cash deposits in bank or building societies and National Savings. In investment terms, government stock is also considered secure although we feel right now it would not be appropriate for someone who must maintain the actual value of their investments.

Whilst there may be little or no risk to the current value of these funds, the income they generate may decline in real terms. Inflation will result in wage increases and price rises and this will erode the value of these investments as purchasing power diminishes. The result is that over time there is a very real risk that the capital value will fall in "real terms".

At present, for instance, a good cash account might generate .50% before tax. Inflation is currently between 1% and 2% depending upon which measure you use. If we use the government target of 2% the effective value of your savings over 10 years falls as follows:

Initial Investment	£100,000
Gross Return	0.50%
Inflation	2.00%

Year	Actual Value	Real Value	Gross Real Income	Net Income 20% Tax	Net Income 40% tax	Net Income 45% tax
1	£100,000	£100,000	£500	£400	£300	£275
2	£100,000	£97,500	£488	£390	£293	£268
3	£100,000	£95,063	£475	£380	£285	£261
4	£100,000	£92,686	£463	£371	£278	£255
5	£100,000	£90,369	£452	£361	£271	£249
6	£100,000	£88,110	£441	£352	£264	£242
7	£100,000	£85,907	£430	£344	£258	£236
8	£100,000	£83,759	£419	£335	£251	£230
9	£100,000	£81,665	£408	£327	£245	£225
10	£100,000	£79,624	£398	£318	£239	£219

As you can see, whilst the investment capital is secure the ***real value*** of your funds and income is falling every year.

7.3 Cautious to Moderate – (Score 32 to 40)

Cautious to moderate investors require a high proportion of their investments in cash and other secure investments. They will, however, accept a limited degree of investments into moderate risk funds which may fluctuate in value in the short term, in return for longer term growth.

Typically a "Cautious To Moderate" investor has between 12% and 41% of their investments in asset backed investments. Based on the Dimensional 20 years back tested data this risk level might generate annual overall returns of between -7% and 14% with an average return of between 0% and 2% before costs.

A cautious to moderate portfolio will have a greater emphasis placed on the security of the underlying capital rather than maximizing the potential investment returns. Lower risk is a good description for these investments as long as they are seen as medium to long term in nature.

The type of investment funds in this category would usually be cash, short dated gilts, and corporate bonds and with profit funds (now not generally available). Over the longer term you could argue that commercial property and some UK equity income (distribution) funds are lower risk as well. Right now we do not consider fixed interest investments as secure, however, they remain the dominant recommended investment where lower volatility is required.

7.4 Moderate – (score 41 to 49)

Moderate investors are looking for a high degree of lower risk investments, however, they are happy to see significant holdings in moderate risk funds which may fluctuate in value in the short term and a further small percentage of their funds in higher risk potentially more rewarding investments.

Typically a "Moderate" investor has between 28% and 57% of their investments in asset backed investments. Based on the Dimensional 20 years back tested data this risk level might generate annual overall returns of between -9% and 19% with an average return of between 1% and 4% before costs.

7.5 Moderate to Adventurous - (Score 50 to 59)

Moderate to adventurous risk investors are prepared to see their longer-term investments in fluctuating collective investments with a small percentage in higher risk areas such as direct equities and specific sector and country funds. They do, however, wish to retain some savings in more secure sources.

Typically a "Moderate to Adventurous" investor has between 45% and 74% of their investments in asset backed investments. Based on the Dimensional 20 years back tested data this risk level might generate annual overall returns of between -11% and 25% with an average return of between 3% and 5% before costs.

7.6 Adventurous – (Score 60 to 100)

Adventurous investors might hold back an emergency reserve then they are happy to have all their investments in asset backed funds, including higher risk sources such as direct equities (with perhaps some unlisted securities included) and specific sector and country funds.

Typically a "Adventurous" investor has between 61% and 100% of their investments in asset backed investments. Based on the Dimensional 20 years back tested data this risk level might generate annual overall returns of between -12% and 32% with an average return of between 4% and 8% before costs.

High risk funds include those where the capital is invested in specific main line stock such as direct equity investments, i.e. British Telecom, Shell etc. Some collective and exchange traded funds (ETFs) would also fall into this category (i.e. emerging countries, commodities etc).

Again, there should be greater potential for capital growth but the risk premium increases in line with the increased volatility. Diversification is limited which often explains why the investment risk increases.

Elevated risk investments are where the capital is invested in smaller, higher risk stock such as those found on the alternative investment market (AIM) or the off exchange (OFEX) or business shares etc.

Often these investments are hard to realise and carry a high risk of complete financial loss. To counteract this, the rewards can be substantial. In many cases, the investments carry with them substantial taxation benefits as governments try to encourage investors to help fledgling industries and depressed areas.

7.7 Summary

These categories follow the Financial Express Risk Groups. As you would expect, 90% of clients fall into the range Moderate through Moderate to Adventurous groups with a score from say 45 to 59.

Risk is assessed differently by different investment advisers. For instance, stockbrokers would point out that 20 or more individual UK stock could be considered a moderate risk investment for a UK investor, whereas we would argue a single UK tracker with perhaps 100 stock would be a moderate risk.

8. LOWER AND HIGHER RISK INVESTMENTS

8.1 Typical Investments Considered Secure Or Lower Risk

- Cash under the bed (but most contents insurance policies will only protect £1,000 against fire or theft).
- Cash holdings (up to £85,000 per person per firm should be covered by the FSCS). You should check that the provider is authorised under the scheme. There is a search facility on their website: www.fscs.org.uk
- Government gilts held from issue date to maturity date (although these do rise and fall in value during their lives).
- National Savings guaranteed products (assuming the UK government does not go bust).
- Premium Bonds.
- State benefits and pensions.
- Guaranteed annuities and pensions (90% of same if the company goes bust).
- Certain guaranteed equity products (as long as the institution guaranteeing the return does not go bust).

8.2 Typical Growth Assets

Growth assets would be everything else from property to equities to derivative products.

9. FURTHER EXPLANATIONS

We have a plethora of further explanations on the topic of investments asset allocation and risk on our website. www.swallow.financial

Please note that whilst every effort is made to ensure that the information contained within this explanation is correct, these notes are by necessity brief and of a generalised nature. Clients should seek specific personalised advice prior to undertaking any arrangement. These notes are named 02.2021 An Introduction To Risk Profiling and was last updated in February 2021. Whilst we have done our best to ensure facts are current to this date laws and options are changing constantly so always check before action.

Investments are subject to market risk, including the possible loss of the money you invest. Bond funds are subject to the risk that an issuer will fail to make payments on time, and that bond prices will decline because of rising interest rates or negative perceptions of an issuer's ability to make payments. Diversification does not ensure a profit or protect against a loss in a declining market. Performance data shown represent past performance, which is not a guarantee of future results. Note that hypothetical illustrations are not exact representations of any particular investment, as you cannot invest directly in an index or fund-group average.

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