WHAT IS RISK AND HOW MUCH (SHOULD YOU) DO YOU NEED TO TAKE?

If you are new to investing, perhaps the most difficult concept to get across is the relationship between risk and reward. These notes try and explain why risk is required (in almost all cases) to achieve long term goals.

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1. WHAT IS RISK?

Risk is the premium you pay to try and generate a real return on your money. All investment involves risk of some form or another.

Invariably clients think of risk as the risk of the actual value of their investment tomorrow being less than it is today. For example, if I invest £1,000 today and the market falls by 20% I only have £800 tomorrow. Investment professionals invariably think of risk as how often and how much an investment goes below or above its mean growth pattern.

It is not possible to guarantee any investment in actual terms. Even governments default so whilst the chances of your premium bonds not repaying their capital are very small, there is still a risk.

Please read our notes on Client Risk Profiles if you want to see how we calculate your risk profile.

1.1 Volatility

In simple terms, volatility is the extent to which the returns on an investment might vary from what we expect each year.

What we expect each year is usually calculated as a "standard deviation". In statistical terms standard deviation is a "mean of means". In other words, in any set of data you can simply calculate a mean average but will include data at extremes of the statistical table.

Standard deviation aims to only take the mainstream data (i.e. using 70% of the data ignoring the other 30% extreme returns) thus creating (hopefully!) a better predictive assessment.

From the Dimensional database, the volatility of assets for the 20 years to May 2020 has been (note this is the return before tax and charges):

			In About 70% Of Time Periods	
Data Series	**Annualized Return**	**Standard Deviation**	**Minimum Return**	**Maximum Return**
Global Bonds	5.39%	2.80%	(1.64%)	12.95%
Cash	2.29%	0.62%	0.17%	5.94%
RPI	2.82%	1.37%	(1.57%)	5.59%
FTSE 100	1.52%	14.08%	(35.37%)	44.65%
UK Value	4.77%	19.23%	(14.46%)	24.00%
UK Equities	3.50%	13.59%	(32.69%)	50.78%
International Equities	6.13%	14.54%	(31.55%)	45.17%
Emerging Markets	8.25%	20.17%	(42.82%)	88.22%
UK Small	4.07%	13.85%	(34.36%)	52.30%
World Small Cap	8.72%	17.00%	(30.11%)	63.62%
Global Property	10.23%	17.77%	(42.81%)	77.90%

These are returns (where possible) in GBP from MSCI and FTSE index data.

Cash has, therefore, returned an average of 2.29% (before tax and charges) in the range 0.17% to 5.94%. Global Property has the highest annualised return with an average return of 10.23% before tax and charges (i.e. 4 times that of cash), but the volatility has been 17.77% (i.e. returns have been between -42.81% and +77.90%). This is great over the 20 years, but a disaster if it is the first year of your drawdown pension.

In investment terms, the adviser wants to invest your money and achieve the best gains for you, but you have to be comfortable with the volatility of the investments chosen. In this example, for a high risk investor world smaller companies are the way forward. However, someone more cautious may be quite happy to accept cash or bonds knowing that their investment will be falling in real terms.

Please remember the above ignores the extremes. In 2008 the fall off in equities was around 35% which is much higher than the medians above.

1.2 Time

Time is the Archimedes lever for investments. The longer the proposed investment period, the more likely it is that predicted growth rates will be achieved.

If you know you do not need to obtain a guaranteed sum from your investments for at least 10 years, in 90% of all known 10 year periods you will see the best returns from equities. However, if you are thinking of a 2 year period equities may only be the best performing asset class in 15% of all 2 year periods.

Changes to legislation has meant that we can no longer consider your life expectancy as the term for your investments. We may have to consider your next generation as well, so for most portfolios the breakdown of funds will remain the same throughout your life ***unless*** there are definite obligations to fund for in a specific time frame.

If you are looking short term then you would normally want investments with very little volatility.

1.3 Systematic Risk

Systematic risk is the market risk. This cannot be avoided and is the reason why asset backed investments generate bigger longer term returns. You accept risk and are rewarded by greater returns.

1.4 Unsystematic Risks

This is the risk associated with the stock (or, to a lesser extent, collective) you are buying. This can be reduced by holding a diversified range of investments. Modern Portfolio Theory (MPT) states that there is an efficient frontier of asset allocation which can match the extent of risk the investor wishes to take against the maximum return.

1.5 What Return Do You Need?

If you are a cautious investor and do not want high volatility then you may have to manage your expectations. Quite often objectives cannot be met without the funds being invested into asset backed investments, so you are left with the stark choice of accepting risk or reducing your objectives. The following example outlines the point:

Here we have a net income objective of £2,500 a month rising every year by inflation of 2%. The funds will be exhausted after 25 years.

Net Of Tax Income Objective	£30,000	
Equivalent Gross Income	£34,500	
Cash Growing At	0.80%	Net Of Tax And Charges
Assets Growing At	3.20%	Net Of Tax And Charges
Inflation At	2.00%	pa
Funds Run Out After	25	Years
Fund Needed If Invested In Cash	£998,000	
Fund Needed If Invested In Assets	£709,000	
Extra Fund Needed For Cash	£288,735	40.72%
Or Change Your Goal To A Net Income Of:	£17,783	

So the cautious investor who is not prepared to risk their capital needs to fund an extra 40% of capital or accept a much lower target.

2. RISK IS INCREASING FOR ALL INVESTMENTS

A recent lecture from Donald Sull of the London Business School provided some interesting statistics. In economic terms, risk is also called volatility or turbulence. His hypothesis was that the rate of turbulence is increasing exponentially. Based on surveys done by his school and others he assessed that comparing the period pre 1970 and post 1970:

- The returns and profits from shares had doubled.
- The rate of big plc companies being bought or going out of business in 10 years had doubled.
- The chance of a top quartile business within an industry being bought or going bust within 10 years had tripled.
- The variation in commodity prices over a 10 year period had tripled up and down.
- The spread between corporate bonds and 10 year gilts had quadrupled.
- The speed at which new technology is accepted by 90% of the world had quadrupled.

The International Monetary Fund (IMF) has reported that there were 4 conquerable global financial crises between 1870 and 1970. Between 1970 and 2009 there had also been 4 global financial crises of equivalent magnitude.

Therefore, regardless of your risk preferences we are all going to have to cope with increasing uncertainty in the years ahead, regardless of where or in what you invest.

3. THERE ARE FOUR MAIN TYPES OF RISK

There are four main areas of risk when considering your investments:

3.1 Capital Risk

The risk that your original capital will be partially, or completely, lost due to investments falling in value or failing completely.

This same risk applies to mature investments, i.e. gains made in previous years can be lost when markets fall.

3.2 Income Risk

Most portfolios rely on the capital to generate income. Income risk is the risk that the income generated from your investments is insufficient for your needs and / or that the income level drops due to market forces (i.e. interest rates fall).

3.3 Liquidity Risk

This is the risk that your investments may be unrealizable when you want to access them. A good example of this would be being unable to sell a house when you need the money.

3.4 Objective Risk

The objective risk is that you may not achieve your objectives if you do not take sufficient risk. For instance, everyone knows that cash is safe in the short term as it will not fall in value but it will also (net of tax) never keep up with prices (inflation). Whilst you may prefer the low risk option of cash, if you choose this then you may not achieve your objectives.

4. HOW MUCH RISK SHOULD YOU TAKE?

There are five main (sometimes conflicting) areas of risk to consider:

4.1 Your Knowledge and Experience

Most clients are happy to buy and rent out residential property yet property is illiquid and can fall very substantially in value so would be classified as high risk. The reason everyone is prepared to take on such high risk choices is that we have all owned property for many years. We understand the fact that sooner or later the value will recover, lack of land being available and the cost of new property has to rise with the cost or labour and materials.

When you put your trust in an investment adviser your level of discomfort can rise if you are not familiar with the investment chosen. Clients who have had ISAs and personal pensions and have bought shares are much more comfortable with understanding the concept of large scale asset backed investments than those who have had very few dealings with such matters.

4.2 What Is The Risk You Must Take To Achieve Your Objectives?

If you need a certain level of income to maintain a reasonable lifestyle and you have insufficient capital to simply leave your money in cash then you ***have to*** take risk. Typically our longer term cash flows assume your investments grow by inflation plus 2% after costs. This requires you to have your savings in asset backed investments (i.e. shares, property). Cash will not be an acceptable investment for your funds as cash does not grow as quickly as inflation and interest is taxed so you will have returns of much less than inflation from cash holdings.

We can vary our long term cash flow returns to show the level of risk you need to take to ensure you maintain your goals, but for most people an element of risk is unavoidable.

4.3 How Much Capital Can You Afford To Lose?

This is a classic “Catch 22”. If your objectives require you to take risk then you may lose more capital than you can afford to. On the other hand, if you do not take the risk there is 100% chance you will not reach your goals.

If you have sufficient capital to cope with a significant fall in values and still achieve your objectives then you do not need to take risk, but you are in the ideal position to do so and hence improve your position still further.

4.4 Your Timescales

The longer the proposed investment period, the more likely it is that predicted growth rates will be achieved.

Statistically the projections we give you in your asset allocation spreadsheet are greater than 90% likely to be achieved over 15+ years. Over 1 to 3 years one cannot predict anything with any certainty.

For most clients nowadays we are assuming their money will remain invested until they die (and frequently beyond that). This being the case we can assume your funds will remain invested for many years to come.

As we have a long time horizon we can afford to take more short term risk in an effort to improve longer term returns.

4.5 How Uncomfortable Are You When Investments Go Down?

Risk tolerance and how you feel about taking risk is psychological. For example, you may say that it is very important that your investments maintain their purchasing power and also that any fall in the value of your investments would make you feel uncomfortable. These two statements contradict each other, since in order for your investments to keep up with inflation they ***must*** be invested into investments which have risk.

We try to assess your feelings in this regard. Whilst we use a well-recognised psychometric test as part of our assessment process, we also need to assess your experience and your attitudes to different scenarios. We will discuss your psychometric results so we can work together to try and find a structure which you are happy with.

5. ARE YOU HAPPY WITH YOUR PORTFOLIO RISK?

By definition we will usually advise on the asset backed element of your savings. When we assess your risk, however, we take into account your other savings and perhaps your level of guaranteed income (pensions and benefits).

If you have a large amount of cash and National Savings then the portfolio we manage is not going to hold cash or fixed interest so you may have a portfolio of investments which is high risk, as we consider your total savings are relatively low risk.

You need to let us know immediately if you are unhappy about this approach.

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 09.2020 What Is Risk & How Much Do You Need and was last updated in September 2020. 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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