Pilling & Co Stockbrokers Ltd

Understanding investment risk

This guide is designed to help you understand investment risk so that you only invest in a manner that is consistent with your attitude to risk.

When people invest their money it's normally because they want to obtain the highest possible return while exposing their money to the lowest possible risk. But, as many investors have found out to their cost over the years, the first part of this objective isn't likely to be achieved without some compromise being made on the second part!

This is because, when it comes to investment and risk, there's no such thing as a free lunch. If you want the opportunity to beat returns from deposit accounts and stay ahead of inflation you must be able to take some degree of risk with your money. Crucially, the higher the potential returns promised by an investment, the riskier it's likely to be.

On the other hand, if you're unwilling to expose your money to any degree of risk, you should be prepared to accept that its value will fall in real terms when inflation is taken into account.

So before you invest your money you should first consider:

- What degree of risk you are prepared to take in relation to your money.
- What you are hoping to achieve and whether it is realistic in the context of the above e.g. if you want maximum capital growth but are not prepared to risk any capital then something is going to have to give!
- Whether you understand and are comfortable from a risk perspective with the types of investments you will be investing in – this applies equally if you are making your own investment decisions on an 'execution only' basis or if you are benefitting from one of our investment managed services.

The wider concept of risk

You may find it useful to read the following extract from *Risk: You and Finance,* a booklet published by the Wealth Management Association (WMA), as it illustrates how risk in an everyday sense is comparable to investment risk:

"Risk, like tax, is always with us
The first thing to remember is that nothing is risk-free. From birth to death, every action that you take has a risk associated with it. One useful way of describing the degree of risk is to compare it with the risk associated with crossing the road. If you look to the right and to the left and nothing is coming, you cross the road and the risk is pretty small. However if there is something approaching then you have to decide what it is, how fast it is going, how far away it is and whether you have time to cross safely. Also, you may decide only to cross at specific designated points.

These decisions, which involve assessing the risks in the situation, will be heavily influenced by your personal knowledge and experience of the speeds at which vehicles can travel. When the road is a country lane, the element of risk is likely to be much lower than if it were a busy high street. The busy high street, though, may have traffic lights and zebra crossings, subways or bridges and there are people who know their way around to guide and help. This will make it safer for you. Nevertheless in all these situations some people still tend to cross roads more quickly than others and some may feel they require assistance. Meanwhile, would anybody cross a motorway?

The answer surprisingly is yes, but those who cross motorways are usually the specialists clad in bright yellow jackets who are only allowed to be there because they are the professionals.

So this example highlights the following points:

- Everything has a risk.
- Risk is a subjective judgment.
- Risk is relative, depending on, for example, how you approach that risk, the nature of the risk and your personal circumstances.
- Risk does not remain constant, but can change when external events change.
- What is considered risky by some may be considered less risky by others.
- And lastly, there are some risks that only a professional should take.

A sensible warning is that you should only take the risks you understand and take professional help if you are not absolutely certain that you can negotiate the risks safely and get to where you want to be."

The full WMA booklet can be downloaded here:

http://www.thewma.co.uk/uploads/files/576/wma_risk_booklet_2014.pdf

The Pilling & Co approach to investment risk

At Pilling & Co, we categorise investment risk in the following three categories:

- Low risk
- Medium risk
- High risk

If you choose one of our managed services, whether on an advisory or on a discretionary basis, we will manage your investments within parameters that correspond to your pre-agreed risk profile. The 'Pilling Investment Risk Guide', which is contained within our client agreement documents for our managed investment services, describes the typical investment types that are included within each of the three categories. Investments may be chosen from each category, but the portfolio will be strategically ‘weighted’ to ensure that it is within your risk tolerance.

For advised (non-discretionary) investment managed accounts, we will make recommendations that are consistent with your risk profile but it is down to you to decide whether or not to proceed.

If you do not subscribe to one of our investment managed services, and you make your own decisions on an ‘execution only’ basis, it is down to you to assess whether or not an investment meets your risk profile.

Context is everything

As we saw in the ‘crossing the road’ example, risk is subjective and also relative to a particular situation.

So while investments can be ‘risk-rated’ to enable a suitable portfolio to be constructed there are various factors which may make one investment suitable for one investor but not for another, even if both appear to have the same risk profiles. For example:

- **Exposure** – the investment may account for a very small proportion of one investor’s overall portfolio, whereas for another investor it may amount to ‘putting all of their eggs in one basket’
- **Access** – even if an investment appears to be well within your risk profile it may not be appropriate for you if you need to access it before it has had chance to generate significant returns.
- **Knowledge/experience** – some investment types may contain certain product features which make them inappropriate for some investors, even if they are marketed as low or medium risk. On the other hand, other investors may have had previous experience of investing in similar investments, and may be more comfortable with these features.

The importance of personal circumstances on investment decisions is demonstrated below:

Importance of context – investing in UK Gilts

UK Gilts are effectively fixed income-producing ‘IOUs’ from the UK government, which pledges to re-pay the original capital to the investor after a certain term. If the investor wishes to come out of the investment early they can do so by selling to other investors, but the capital value may be lower or higher than the price originally paid.

The UK government is generally regarded as unlikely to default on its debts so Gilts should represent one of the safest/lowest risk forms of investments. But, as we can see from the examples below, what is safe or low risk for one investor may not necessarily be so for another:

Investor 1: Clive

Clive received an inheritance of £20,000. Having never invested before, he classed himself as a Low Risk investor and decided to invest all of the money in UK Gilts with a term of five years. This is because he had read that they were the safest types of investment and that they would meet his objective of receiving regular income with a full return of capital.

However, two years into his investment, Clive wanted to buy a caravan and, with no other money available, he decided to sell his Gilts.

Given that the five year term had not elapsed, Clive's only option was to sell the Gilts to other investors. Unfortunately, the price they were willing to pay him for his Gilts was significantly less than he had paid for them because interest rates were currently high, which made Gilts less appealing. In fact, when Clive factored in how much income he had received from the Gilts, he discovered that he was worse off in real turns than if he had simply held his money in a deposit account.

As a result, Clive was disappointed with his investment and confused that something he'd considered to be low risk had left him worse off than if he'd left his money in a deposit account.

Investor 2: Diane
Like Clive, Diane also received an inheritance of £20,000. Having had some previous investment experience, she classed herself as a Medium Risk investor but decided to hold back £2,000 to put in her deposit account to help cover short-term emergencies.

For the remaining £18,000, Diane decided to invest in a mixture of equities, Gilts (with terms varying from five years to ten years), corporate bonds and property funds. She used any income generated from these investments to supplement her deposit account.

Two years down the line, at the same point Clive was about to buy his caravan, Diane needed to pay for some repairs to her house. Luckily, the amount she had saved initially plus the income she had been receiving from her investments was enough to cover these repairs while leaving her with enough left over for further emergencies. However, a further five years down the line Diane decided that she wanted to sell all of her investments and put the proceeds towards the purchase of a new house. By then, interest rates were still high, and Gilts were still selling for less than their value at issue.

Diane didn't suffer the same fate as Clive because:

- While Diane made a capital loss on her 10 year Gilts, they accounted for only one part of her portfolio and the losses were more than offset by gains made elsewhere.
- She hadn't needed to access her investments before they had chance to achieve reasonable growth (investing for seven years as opposed to Clive's two years).
- She had the knowledge and experience to realise that she should create and maintain an emergency fund as this would reduce the chance that she would need to sell her investments when market conditions were not favourable.

Different risks for different goals

Often, investors have different attitudes to investment risk for one investment ‘goal’ than for another. For example, some investors may decide to take a more adventurous approach to their retirement planning than to saving for their child’s university education, if their retirement is further away in the future (because the longer timeframe will give their investments more chance to ‘weather out’ short-term market fluctuations).

When you take advantage of one of our managed investment services we ask you to complete an investment questionnaire which enables us to assess your investment objectives, financial resources and personal background. This helps to ensure that any investments we recommend, or manage for you on a discretionary basis, are suitable for you.

Product literature descriptions of risk

If you invest in an investment product (e.g. funds such as Unit Trusts or OEICs) on a non-discretionary managed basis you will be issued with product literature which describes the fund’s risk profile. This is normally in a standardised format so allows you to compare the relative risk profiles of different funds based upon their volatility (that is, on how much the value of the investment has gone up and down over a given period of time).

While this is useful, you should be careful not to rely solely on the risk profile information to decide whether or not it the fund is within your risk tolerance. This is because the risk profiles will not factor in your personal circumstances which, as we have seen, are vital to determining what degree of risk you can afford to take.

So it’s vital that you read and understand all of the product literature provided before making an investment decision. If you take advantage of one of our managed services, whether on a discretionary or advised basis, we will use our knowledge of your personal circumstances to ensure that we only invest your money in funds that we feel are suitable for you.

Products/funds versus individual stocks & shares

Investment products/funds and investment companies are normally deemed to be less risky than individual stocks & shares because they spread their investments over several areas but the key to how risky or not they are is what they invest in.

Some products and funds have features which make them riskier than they first appear. For example, some Exchange Traded Funds and structured products may not necessarily be high risk in the traditional sense (e.g. they may not appear volatile) but they may have certain complexities that make them not suitable for all investors. Therefore, it's vital that you read all of the product literature and ensure you understand the risks before investing in any fund or product.

If you take advantage of one of our managed services we will ensure that we only invest your money in such products if we feel they are appropriate for you and we will limit your exposure in a way that is consistent with your risk profile.

If you wish to invest in certain complex products on an execution only basis our regulator requires that we ask you for detailed information about your knowledge and experience of such products. This is so that we can determine, on a general basis, whether or not it's potentially appropriate for you to invest in them. However, we will **not** take your risk profile into account, and you will remain responsible for deciding whether or not it is suitable to proceed.

And Finally…

So to summarise:

- Risk is **relative** to your needs & circumstances
- Risk is **subjective** and depends upon your knowledge and experience
- Risk should be **mitigated** wherever possible by **diversifying** your investments and by only investing in investments when you **understand** and are comfortable with the risks involved (or by employing a professional investment manager to manage your investments within parameters agreed with you at the outset).

Remember, there is no such thing as an investment with no risk. Even deposit accounts are subject to inflationary risk (that is, the risk that purchasing power will decrease over time). The biggest risk you can take is to ignore your finances!