Appendix

Plan Money

Risk

v16.11
PC

What the word 'risk' means to you and why it is a fundamentally important part of the financial planning process.

Investing is not about trying to get the highest return – that's gambling. Investing is about setting an objective, then striving to achieve it while taking the least possible risk.

Risk Appetite and Sentiment

In everyday terms people often think of risk as being the prospect of an undesirable outcome, such as making a financial loss. Another way of putting it could be the chance of not meeting your goals or objectives. Risk exists in a number of different situations. For example: by financial risk we mean the volatility associated with the returns from investments. By insurance risk means we or our families are not protected financially following unforeseen events such as death, serious illness or incapacity.

Some individuals are more able to tolerate financial risk than others. Financial risk tolerance can be broken down into two main areas:

1) **Ability to take risk** or 'risk capacity'

2) **Willingness to take risk** or 'risk attitude'

An individual's **ability to take risk** relates to their financial circumstances and their investment goals. Generally speaking, the higher the individual's level of wealth and income, relative to any liabilities they have and the longer their investment horizon, the more able they will be to take financial risk and the greater their risk capacity. Consideration of these issues should be key to the planning process.

An individual's **willingness to take risk**, on the other hand, has more to do with the individual's psychology than with their financial circumstances. Some people will find the prospect of volatility in their investments and the chance of losses distressing to think about. Others will be more relaxed about those issues. It is possible that an individual's ability to take risk conflicts with their willingness to do so. For example, a wealthy investor with substantial capacity to take risk might have a cautious attitude. A less wealthy individual with a finely balanced financial situation may have an aggressive approach to investment and be keen to take on risk in pursuit of high returns.

It is also possible that the attitude to risk varies by objective – one might be willing to take on considerable risk with assets that are earmarked for a particular goal, but not with others allocated towards a different goal. While this kind of separation might not make sense from a purely financial point of view, many investors do use this notion of separate 'mental accounts'.

[source: Barrie + Hibbert research 2007]

Types of Investment Risk

Concentration risk
Having a significant portion of your wealth or savings in one or only a few assets. Otherwise known as 'having all your eggs in one basket'. This could include an investment with just a small number of holdings, meaning that a fall in value could have a significant impact on the overall value of your investment. This risk is best overcome by having a well-diversified portfolio with assets that negatively correlate to each other. This type of risk could also include relying on just the downsizing of your home to fund retirement or only investing in, say, property. i.e. the success or failure or your investment is heavily reliant upon just one asset class or market.

Geographical risk
Having a significant portion of your investment portfolio in a small number of countries, meaning that you are reliant solely on the economic prospects of those economies. e.g. holding a single investment fund which has a mandate restricting it to investing in just the UK, or just Europe.

Geopolitical risk
The impact on investment markets and global assets such as commodities which are as a direct or indirect result of political decisions. e.g. going to war, trade embargoes or natural disasters.

Inflation risk
The risk of the rising cost of living eroding the future value of capital and/or income.

Legislative and taxation risk
The risk that changes is legislation and taxation rules impact upon a particular strategy.

Liquidity risk
Not being able to easily liquidate, or sell, an asset. This can occur when investing in property because the asset can only be sold once a buyer can be found. If an asset needs to be sold quickly, the value realised can potentially be lower than expected e.g. in a depressed market.

Longevity risk
The risk of you outliving your money.

Timing risk
The risk of trying to 'time the markets' and make decisions with strong a conviction of future market movements or other financial factors such as interest rates or inflation.

The Risk Profile Assessment Process

Plan Money advocate the completion of a Risk Profiling Questionnaire that can be used in assessing financial risk attitude. The idea is that the individual completes the questionnaire and receives feedback on their score. This feedback can then form the basis for an understanding of how the score was arrived at and ensure it is accurate and accepted bearing in mind other aspects such:

- Actual capacity for loss
- Volatility tolerance
- Timescales
- Investment knowledge and experience
- Active interest taken in the investments in terms of strategy, market timing and decision-making
- Overall sentiment and behaviours

We have identified the Financial Express Analytics eValue Attitude to Risk Questionnaire as what we believe to be the most robust for this purpose. It has been designed in line with the latest FCA guidelines [issued January 2011].

The risk scores are produced on a scale of 1 to 5 to define a person's risk profile, where 1 represents the lowest risk and 5 the highest risk.

Risk level 1 – Cautious
You are prepared to take only a small amount of investment risk and it is important to you that your capital is protected. This means that your portfolio will concentrate on investments that provide low returns in the long term but present lower risk to your capital. Only a small amount of riskier assets will usually be included in your portfolio in order to increase the chance of obtaining better long term returns. A typical Cautious investor will be invested mostly in fixed interest gilts and bonds as well as in cash, with a small element in equities and property that can boost longer term returns but are associated with more risk. Using a broad range of assets gives you a varied portfolio and that diversification helps to reduce the overall levels of risk.

Risk level 2 - Cautious to Moderate
You are prepared to take limited investment risk in order to increase the chances of achieving a positive return but you only want to risk a small part of your capital to achieve this. A typical Cautious to Moderate portfolio will usually have the larger part of the portfolio invested in fixed interest gilts, bonds or cash that are low risk but offer only low returns. The remainder of the portfolio will usually be invested in equities and property which can boost longer term returns but are associated with more risk. Using a broad range of assets gives you a varied portfolio and that diversification helps to reduce the overall levels of risk.

Risk level 3 – Moderate
You are prepared to take a moderate amount of investment risk in order to increase the chance of achieving a positive return. Capital protection is less important to you than achieving a better return on the investment. A typical Moderate investor will usually invest in a variety of assets to obtain diversification and therefore reduce risk. Equities and property, which can boost longer term returns but are associated with more risk, would often account for a higher proportion of assets than fixed interest gilts and bonds or cash. At shorter investment terms the proportion of higher risk assets is usually reduced. The range of asset types helps reduce the overall risks while increasing the chance of better returns.

Risk level 4 - Moderate to Adventurous
You are prepared to take a medium degree of risk with your investment/s in return for the prospect of improving longer term performance. Short term capital protection is not important to you and you are willing to sacrifice some long term protection for the likelihood of greater returns. A typical Moderate to Adventurous investor will be invested in equities but with other assets included to provide some diversification. There may be a small amount of specialised equities within the portfolio, which focus on a particular sector of the economy or relate to a particular market or industry. Specialised equities can boost longer term returns but are associated with more risk than standard type equities.

Risk level 5 – Adventurous
You are prepared to take a substantial degree of risk with your investment/s in return for the prospect of the highest possible longer term performance. You appreciate that over some periods of time there can be significant falls, as well as rises, in the value of your investments and you may get back less than you invest. This strategy holds significant risk in the shorter term. A typical Adventurous investor will usually be invested entirely in higher risk assets such as equities. There may also be a proportion of the investment in specialised equities, which focus on a particular sector of the economy or relate to a particular market or industry. Specialised equities can boost longer term returns but are associated with more risk than standard type equities.

The information contained within this document is for information only and does not constitute advice.

Plan Money Ltd is regulated by The Financial Conduct Authority.