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HOWE MAXTED GROUP
INDEPENDENT INSURANCE BROKERS & FINANCIAL ADVISORS

Investment UPDATE

Understanding your attitude to risk

A guide to assessing risk when it comes to financial decisions.

Risk is a shifting and ever-present aspect of modern life and something that we all come into contact with at some point. From the adventures we have as children to the financial decisions we make as adults, our attitude towards risk is an indelible part of who we are.

When it comes to investing, however, it is important to think about risk objectively and not let our subjective emotions cloud our judgement, although our own views and opinions are very important.

Being able to do this successfully means both understanding the different risk levels of investments available in the market, but also how risk is related to the potential returns on offer.

Understanding risk

Any aspect of financial planning involves accounting for risk in some way. This is because there are a number of distinct types of risks associated with different assets (or investment classes) and market choices.

At one end there is the risk that you may be the subject of fraud and have your money taken. At the other end are the uncertainties that come from the difficulty of trying to predict the future movements of the market.

Inflation risk

Inflation risk comes from rising prices making your money worth less.

If your return is not high enough, your gains could be wiped out by inflation and tax.

Investments with higher potential returns can help you beat inflation, but these kinds of investments invite other kinds of risks.

Market risk

For many investors, this stands next to inflation as the main risk to consider. Market factors have a strong effect on so many other aspects of economic life that it should always be considered.

Liquidity risk

This refers to the idea that an investment cannot be bought or sold quickly enough in order to lessen, or completely prevent, a loss from occurring.

Credit risk

A borrower might fail to repay a loan or otherwise meet contractual obligations.

Counterparty risk

When entering into a contract with another party, both are encountering risk from either one failing to meet the obligations of the agreement.

Shortfall risk

By failing to reach your investment goals by having a lower return, you have suffered shortfall risk.

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Understanding your attitude to risk

Understanding your attitude

Generally, the greater return you want on your investment, the more risk you need to be willing to accept. There are 4 main things to consider when thinking about your own attitude towards risk:

- your circumstances
- your goals (you also may have different attitudes to risk for different goals)
- your subjective feeling towards financial risk, known as your attitude to risk or your tolerance to loss
- your capacity for loss, i.e. how much you could afford to lose without affecting your goals.

Your personal circumstances are more than simply how much you have right now and how much you are willing to lose.

Knowing what you can afford to lose is the important part. Every chunk of money lost represents a blow to your financial plans, whether they are personal, business or both. How much would you have to lose before your life unacceptably changed for the worse?

The timescales of your goals may influence how much risk you are willing to take on. Generally, having a longer timeframe gives your investment more time to grow and more time to recover if it falls in value during that time.

As your long-term goals become short-term ones though, you may want to transfer into less risky assets in order to lock in your gains and to reduce any risk of further fluctuations.

Risk questionnaire

Professional advisers can help you determine your attitude towards risk. Some examples of the type of questions they may ask are:

If you were offered £500 or the chance to gamble it for £500,000, what would you do?

Would you go for the £500,000 or would you take the free and guaranteed £500?

If a fund you are invested in fell by 50%, what action would you take?

Would you pull your money out, take advantage of the low cost and put more money in or take a good look at the fund and judge it based on that?

How long do you want to invest for?

Do you want to be doing this for less than 5 years or over a decade?

What kind of return do you want?

Are you satisfied with the idea of ticking over with a stable return of 1% or 2%, or do you want a double digit return but don't mind having periods of losses along the way?

In general, how are your finances?

Do you budget each month and put aside money into a rainy day or emergency fund, or do you spend your entire income every month?

We can help you determine your risk appetite.

Reducing risk

There is no escaping risk, but there are strategies for trying to reduce it. You can either make less risky investments or you can try and understand risk and work with it.

The first strategy is allocating your assets widely among different investment classes so that it includes stocks, bonds, cash and even property. This way you can tailor your investments to the level of risk you are comfortable with, which is sometimes referred to as a balanced portfolio.

The second widespread strategy is diversification. This is where you buy a single asset type from a range of different sources to help hedge against the risk of a single entity's poor performance doing disproportionate damage.

If you want to buy stocks, buying 1 from 40 companies is usually considered better than buying 40 in 1 company. It is unlikely all 40 companies will do badly at the same time, unless there is a sector slump or macro-market event.

Everyone's attitude to risk is different and every investment strategy can be tailored to suit the risk appetite and outlook of the investor. We can help you get to the bottom of what you want to achieve and how best to go about doing it.

Contact us to discuss investment today.