CAMPBELL & McCONNACHIE

chartered financial planners

Working out your attitude to risk

Your attitude to risk will determine your investment strategy.

Investing is an inherently risky activity and there is no guarantee that you will meet your goals.

As well as the specific types of risk that come from different kinds of investments, each individual must be aware of their own particular attitude to risk. Just as some people are skydivers and others are not, some people are able to stomach fast-moving and higher-risk investment environments.

An understanding of risk means thinking about the different investments in the market as well as the potential returns. This means you will be able to think objectively about risk in a way that allows you to effectively modify your investment strategy.

Different kinds of risk

The first step is understanding that there are many different kinds of financial and investment based risk that can have different effects on an individual's position.

There are a range of risks associated with any financial decision, from incorrectly anticipating market movements to having your details stolen or suffering a technological failure.

Here are a few different examples of specific kinds of risk:

Inflation risk

Rising inflation means higher prices and your money being worth less.

This means that a low return on your investment might not be enough to counteract inflation and tax liability. The obvious response to this threat would be to make investments with higher potential returns, but this means taking on additional risk.

Market risk

Every investment takes place within a market, whether local or global, and market factors can have powerful effects on a person's financial position.

Market risk is also known as systemic risk and is caused by macroeconomic factors that affect all assets. For example, a prolonged recession could dampen consumer spending, which in turn leads to diminished business performance that lowers the values of a person's investments.

Specific risk

Specific risk relates to individual assets or groups of assets and is the opposite of systemic risk. For example, if you are heavily invested in one particular company and the CEO is forced out by shareholders in an acrimonious fashion, this is a specific risk to your investment.

Shortfall risk

If you set an investment goal and base your financial planning around it, you face a risk that you might fail to reach your goal.

For example, if your goal is to use your investment income to add to your pension income and your investment return is lower than expected, your retirement income will be lower than you planned.

We can help you understand the different kinds of risk you may encounter.

Your capacity to take risk

Your ability to take on certain kinds of risk will depend on 2 main factors: your capacity to take on that risk and your attitude towards it.

If your capacity for risk is low you will be limited in the kind of investments you can make.

Goals

It is unlikely that you will be investing your money with no end goal in mind. Your goals are a significant part of your overall willingness to take on risk.

The timescale of your goals is an important consideration:

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Short-term goals

These are goals you want to achieve relatively soon, such as:

- buying a car
- saving up for a deposit on a house
- paying down debts
- building up a bank of savings.

The shorter period of time between setting these kinds of goals and achieving them means that the level of risk you undertake is likely to be lower. You will have less time to correct any losses, so a steadier, lower risk investment (even though growth may be slower) is likely to be preferred.

Long-term goals

The most common long-term goal among investors is to boost the resources they will have in retirement.

The longer timeframe means that there will be a greater potential for investments to move over time and therefore, higher risk, potentially higher return strategies can be employed.

We can assist you in setting realistic and achievable financial goals.

Your financial circumstances

Your willingness to take on risk will not equate to much if you are financially unable to take on the consequences of not making the return you want.

Giving yourself enough financial room to take on additional risk centres around 2 main factors:

- clearing debt - it is important to try and resolve any nagging liabilities so that they do not continue to divert your resources
- savings and emergency funds - having savings ready will allow you to absorb temporary losses or lower than expected returns over a set period of time.

Your attitude towards risk

On a more personal level, working out your own attitude towards risk involves asking yourself some important questions. Talking to a professional adviser is another useful way of determining how comfortable you are with risk.

Some questions you may want to ask:

What is your ideal level of return?

Is a stable return of 1% or 2% every 6 months for 15 years better than a double digit return with wild swings?

What would your instinct be if a fund you have money in fell by 50%?

Would you buy up more of the fund to take advantage of low process or would you move your money elsewhere?

How do you feel about the current state of the market?

Is it time to be cautious or are there big opportunities for the brave?

Creating the right strategy

Once you have an accurate idea of how you feel about risk and how that intersects with your capacity and goals, you can begin to tailor a strategy. This may involve adjusting your attitude to risk for a particular goal, or adjusting your goals to align with your attitude to risk.

While a full exploration of the different investment options available is beyond the scope of this article, there are 2 further aspects to consider from risk perspective.

Diversification

Diversification is the practice of spreading your investment across different asset classes and investment types in order to minimise the chance of making a large loss.

Diversification is perhaps the main risk-reduction strategy with the thinking being that a few smaller losses are better than 1 large one.

To diversify your portfolio you should aim to:

- spread your investment across cash, stocks, bonds, mutual funds and property if possible
- vary the risk of your security investments so that even among individual asset classes there is a diversification of risk
- invest in different sectors of the economy, countries and/or regions.

Lump sum or regular investments?

Do you want to invest a lump sum in one go or do you want to add to your investments regularly over time?

Lump sum investing could see you get a larger return quicker and over the longer term, but losses will be more pronounced.

Investing regularly allows for more flexibility in terms of diversification and tailoring your strategy.

As always, you should seek professional advice and guidance before committing your money. The world of investing is filled with jargon and obtuse concepts that can be time-consuming to learn. Good advice can often be the difference between a well thought out plan and one that doesn't suit your needs and appetite.

Talk to our team about your investment strategy today.

Important Information

The way in which tax charges (or tax relief, as appropriate) are applied depends upon individual circumstances and may be subject to change in the future.

This document is solely for information purposes and nothing in this document is intended to constitute advice or a recommendation. You should not make any investment decisions based upon its content.

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