FINANCE UPDATES
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FINANCIAL PLANNING

HOW MUCH RISK ARE YOU HAPPY WITH?

The role of risk recommending investment products.

From buying a house to booking a holiday, most decisions we make contain varying degrees of risk.

Take the COVID-19 pandemic, for example. Some people refused to entertain the idea of wearing a mask from the start of the pandemic, while others continue to wear masks even though it's no longer mandatory.

Using this example, it's easy to label mask wearers as risk-averse and those who didn't as risk-takers. But with investments, few people fall into those extremes.

Various psychological elements come into play when we assess your appetite for risk – generally referred to as tolerance to loss. Are you someone who panics at the first sign of a market downturn, or perhaps you're someone who follows the herd?

Your ability to absorb losses without affecting your financial plans, called your capacity for loss, is also very important.

Whatever your disposition, understanding the different types of risks and how much risk you are willing to take is essential before we recommend suitable options or products to invest in.

Let's look at three of the biggest financial risks to investors in September 2021, and how we might balance those investments.

STOCK MARKET RISK

Global stock markets suffered historic losses of more than 20% between January and March 2020, amid a massive sell-off tied to the start of the pandemic.

The FTSE 100 Index fell 25% in Q1 2020, while the Dow Jones Industrial Average plunged 23%. In both cases, these were the biggest quarterly drops since 1987.

It's difficult to overstate how dramatic this stock market moment was, or how much panic was in the air at that time, especially with so many people's pensions at stake.

Quick, sharp drops like this, however, are much easier to stomach than slow declines. By the time most people had spotted the downturn in their March 2020 statements, markets had started to rebound.

Stock markets always fall at some point. It's those who invest for the long-term that are usually in the best position to ride out these inevitable storms and benefit from the ensuing recovery.

INFLATIONARY RISK

The latest threat to positive market sentiment involves inflation. Official figures showed that the main rate of inflation, as measured by the Consumer Prices Index, increased from 0.7% to 2.5% in the six months to June 2021.

Just last month, the Bank of England revised up its forecast that inflation will rise to 4% this year – double the 2% target rate.

While that will force food and energy prices up, investors should not be complacent about inflation. Some portfolios might have investments which won't perform well in an inflationary period.

Low interest rates since the financial crash of 2008 have seen the value of assets that thrive in a low-inflation environment boom, and conversely these may struggle if inflation continues to rise.

Examples of these include government bonds and also investments that can act as bond proxies, such as reliable, high-quality, blue-chip companies.

CRYPTOASSET RISK

The value of any investment can fall as well as rise, and you might get back less than you originally put in. Cryptoassets take this old adage to extremes.

There has been a lot of publicity about the returns on offer from Bitcoin, which hit an all-time high of $64,870 in April 2021.

In the two months that followed, the value of this cryptocurrency plummeted by more than 50% to around $28,890 in June 2021.

The Financial Conduct Authority (FCA) has said Bitcoin investors "should be prepared to lose all their money" if the value of their unprotected investment collapses.

As such, these types of cryptoasset carry very high risk and, as they are an unregulated investment, we can only recommend these in very limited circumstances to specific client categories.

SPREADING RISK & DIVERSIFICATION

With various asset classes to choose from, not putting all your eggs in one basket is vital if you are to reduce potential losses.

Most investors spread risk through diversification, which sees them invest in assets associated with different levels of risk.

The theory is that if you have invested solely in one asset, sector or region, you might not get back what you put in when this investment begins to drop in value.

Diversification involves investing in non-correlated asset classes. While one part of your portfolio falls in value, the others should not go the same way. Some assets go up in value.

HOW TO DIVERSIFY?

We've already mentioned choosing a range of asset classes is the foundation of any effective investment strategy. Moving that on, you could diversify by sector or regions around the world.

Let's focus on diversification by sector. If you held shares in a central bank back in 2006, your investment might have prompted you to snap up shares in other banks. When the banking crisis struck the following year, the value of your shares in the financials sector would have taken a significant hit.

So, once you have chosen the asset classes you want in your investment portfolio, you can diversify further by investing in different sectors which are not closely linked.

For example, if the metals and mining sector experiences a downturn, it will not necessarily impact any investments you have in the healthcare sector. This means the latter investment is protected from the dip in the former sector.

Spreading your investments around the world can usually help to reduce the effects of stock market movements as you will not be tied to the economic conditions of one country.

A word of caution, however, is that this approach can carry additional risk to your investment. Developed markets like the UK, the US, and Japan are more stable than emerging markets such as Brazil, China, and India.

Overseas investments also have currency risk as exchange rates can vary and change the valuation in the pound, both up and down, without the asset's value changing.

Investing in overseas stock markets can certainly help you diversify your investment portfolio, but you do need to be aware of and comfortable with the risks.

The same diversification principles apply if you are **buying shares in companies**. Don't just invest in one listed company, spread your investments across a range of companies.

Using an **investment fund or trust** can be a useful way to diversify your investment portfolio. They can invest in a variety of shares, bonds, properties, or currencies

Investment funds spread the risk around. With a bond fund, for example, you might have cash in hundreds of different bonds. With equities, you could have dozens of shares in a country, sector or market.

HOW CAN WE HELP?

In these volatile times, having the support of a financial expert can help establish an investment strategy based on your tolerance to risk, your timeline, and sound principles.

Get in touch for a review of your investments portfolio.

IMPORTANT INFORMATION