M&G Investments

The M&G guide to

Risk

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Please refer to the glossary found on page 15 for an explanation of the words highlighted in **bold** throughout this guide.

What exactly do we mean by risk?

Risk in a nutshell

When you think about risk in life, you think about potential hazards or increased levels of danger. **Risk** in finance and investment means something slightly different – it simply means the level of uncertainty in the outcome of your investment.

All investments carry a level of risk, and a higher risk investment doesn't mean that you should avoid it at all costs. It simply means that there is less certainty in the outcome.

When you make an investment, you can never be absolutely certain what you'll get back when you cash it in. Risk is implicit in all investments. To achieve a return, you must therefore be prepared to take some form of risk. Even so-called 'risk-free' **assets** are not completely without risk.

Deciding your goals

Your investment goals are the first thing you need to think about when choosing your level of risk. Your goals should depend on your individual circumstances, attitude to risk and your stage of life. Are you investing for the long term (10 years or more) to meet a target amount, for example, to pay off the mortgage, save for your children's education or provide a decent income in retirement? If so, you might be prepared to take bigger risks to boost returns over a longer timeframe. Alternatively, you might be saving for the short term or just be looking for a steady income – in which case, it is unlikely that you will want to take much **capital** risk.

The reasons you're investing, the level of risk you're prepared to take and when you'll need access to your money, should influence the types of investments that you make and hold.

- In life, risk is generally seen as something to be avoided. With investment, risk could be beneficial
- A higher risk investment doesn't mean an investment should be avoided – it simply means the outcome is less certain
- The level of risk you take should depend on your investment goals
- If you're investing for the long term, you may choose a higher risk investment. If you're investing for the short term, you may choose not to take a lot of risk

Risk versus reward

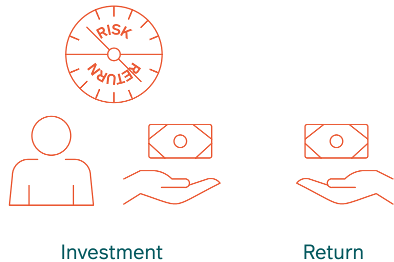
The risk/reward ratio explained

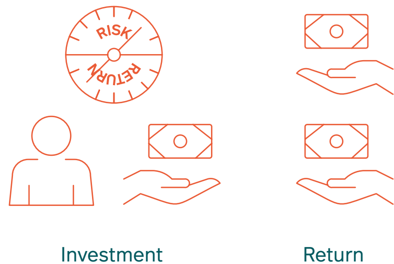
The illustration here shows how risk can affect your investment. If you choose a low-risk investment, the initial sum invested is not expected to grow very much. But if you choose a higher risk investment, your initial sum could grow considerably.

Be wary of stockmarket fluctuations

It's important to remember that no investment is guaranteed – the stockmarket will fluctuate so your investment may not grow as predicted and you may not get back your original sum (capital).

- The more risk you take, the more your investment has the potential to grow
- There are no certainties with investments, so taking a higher risk does not guarantee a higher return and you may not get back your original investment (known as the capital)





Risk is the possibility of **losing some, or all, of your capital** (your original investment). Risk refers to uncertainty. All investments carry a level of risk.

Balancing risk – too much or too little?

The problem with not taking enough risk

If you're too cautious with your investment, you may not grow your money as much as you'd like to. For example, if you're investing over the long term (10 years or more) for your retirement, but choose a low-risk investment, you may not have enough to live on when you come to retire.

To ensure you have enough to meet your needs, you may choose a higher risk investment early on and then switch to a lower risk investment with a regular income on retirement.

- It might seem sensible to always choose a low-risk investment, but this could leave you without enough money for your needs, especially in the long term
- Over-confidence could encourage you to take too much risk – a high risk investment may have performed well in the past, but that is no guarantee of future growth

The problem with taking too much risk

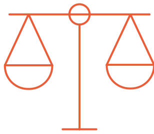
Being too confident and taking too much risk could also leave you without enough money for your needs. If you choose a high-risk investment that has performed well in the past, you may have high expectations of its future performance. But as past growth is no guarantee of future growth, you may not make as much as you expect, which is particularly problematic if you need a certain amount of money to pay off your mortgage or to live on during your retirement, for example.

Taking too much risk in the short term could also prove problematic. High-risk investments may be **volatile**, which means they can fluctuate quite a lot year on year.

So although a high-risk investment may grow your money over the long term (10 years or more) because you can 'ride out' the short-term dips, putting your money into a volatile investment for a short time may leave you with very little growth or less money than you originally invested.

Whatever your investment objectives may be, it's important to be sure that your **portfolio's** balance between risk and return is right for you. For example, taking on too much investment risk could result in your capital fluctuating, while not taking enough risk may mean that your investment may struggle to meet your **capital growth** requirements.

Balancing the risk



Risk	**Your investment objectives**
Volatility	Timescale
Perception	Capital growth
Tolerance	Regular income

Different types of investment and their level of risk

Investing in a bank or building society

Your money will only grow in line with interest rates, so when interest rates are low, your capital growth is quite limited.

Investing in bonds

Investing in **bonds** is like giving a fixed-term loan to a company (or a government). You can receive income from interest on the 'loan' for an agreed length of time. Bonds are considered to carry less risk than other types of investments; however, the amount of risk varies according to how secure the bond issuer is considered to be. Bonds issued by governments are generally considered to be more secure.

Investing in equities

Equities are shares in a company. The growth of your investment depends on the fortunes of that company, the industry it operates in and the general economic climate. Although there is no limit to how much your investment could grow, you should also be aware that the price of a share can fall to zero. You may not recoup your original investment.

Investing in property

The amount of income you can make from property can fluctuate according to the general trends of the residential or the commercial property market in the economy. Although property is considered more stable than equities, your initial investment is still not secure.

For more information please see the M&G guides to **bonds** and **equities**.

The value of investments can go down as well as up so you might not get back the amount you put in.

- Saving in a bank or building society is low risk, but your money also has the least opportunity to grow here
- Bonds and equities give you more opportunity to grow your money, but your original investment (capital) is not secure
- Investing in property is considered relatively stable compared with the returns from bonds and equities, but your capital is still at risk

Find your level of risk

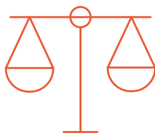
Make sure you are comfortable with the level of risk you decide to take with your investment.

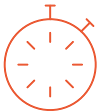
Choose an investment portfolio with the right balance of risk and return for you.

The length of time during which you can invest, combined with your investment goals, will help you choose the right level of risk for you.

How to find your level of risk

As you'll have read on page 5, there are problems with taking too much risk and not taking enough risk with your investment. To find the level of risk that's right for you, you need to think about your plans:





How much time do you have to allow your investment to grow?

How much money would you like to have at the end of your investment period?

Your personal investment timeframe and your individual circumstances (for example, your age and stage of life) will give you an idea of whether it would be appropriate to take more risk in order to achieve your investment goals.

Different asset classes have different risk and return profiles. For example, equities may produce the highest long-term returns, but depending on the prevailing economic situation, they may also carry a greater risk to your investment than bonds or property. On the other hand, cash carries the lowest level of risk, but as a result, has historically produced the lowest returns. We believe that regularly reviewing your portfolio is fundamental to long-term success.

The value of your investments can go down as well as up so you might not get back the amount you put in.

Common types of risk with investment

We introduced you to different asset classes on page 7 of this guide. Each asset class can be affected by one or more types of risk.

Here are some common types of risk and a guide to the asset classes affected by them:

Capital risk

Every investment, even cash above £85,000 held in one bank or building society, carries the risk that you may not get back your initial sum invested (capital). This is known as capital risk.

As we explained before, equities and bonds carry a higher capital risk than cash. But out of the two, equities carry a greater capital risk.

Capital risk in equities

Equities are shares in companies. When you buy equities you become part-owner of the company and your investment successes depend on the fortunes of the company.

As share prices fluctuate according to company performance, stockmarket trends and other factors, there is greater capital risk. While there is no limit to how much a share price can rise, it can also fall to zero – you may lose part of, or all of the initial sum invested.

Capital risk in bonds

When you invest in bonds, you 'loan' a company or government your money over a fixed period of time. That company or government will pay you 'interest' on the loan for the length of the bond period, at the end of which it will pay back your capital.

The capital risk in bonds comes if the company or government goes bankrupt during your investment period. But even if that happens, bondholders are more likely to recover some of their losses than **shareholders.**

The value of investments can go down as well as up so you might not get back the amount you put in.

- Each type of investment (asset class) has its own level of risk and return
- The risk and return profile of an asset class is based on past performance and market conditions
- Asset classes are affected by a number of different types of risk – some types of risk are common to all asset classes

Credit risk

This is a risk associated with bonds.

If a company or government that has issued bonds (also known as the issuer) fails to make interest payments or repay the initial loan amount, a 'default' occurs.

Each issuer has a credit rating that indicates its ability to pay back its loans. If an issuer's credit rating is downgraded (by a credit rating agency) it suggests that the risk of it defaulting has increased, and the value of bonds issued by the company or government could fall. If this happens, an issuer might choose to offer higher interest payments to entice investors who are taking a greater risk by lending money to that company or government.

Governments with solid public finances typically have a lower probability of default on their debt. Therefore, they are more likely to pay a lower level of interest. Companies tend to offer larger interest payments on their bonds to compensate for the higher risk that they could default.

Currency risk

This is a risk associated with investing overseas or in international companies.

As a UK-based investor, if you invest overseas, you'll need to convert your money back into sterling when you want it back. As currency exchange rates change, so will the value of your investment.

If sterling strengthens against the currency of the country in which you've invested, this will lower the value of your foreign investment. If sterling weakens, your foreign investment will increase in value.

Inflation risk

Inflation risk can affect all types of assets.

The higher the rate of inflation, the lower the actual value of future returns. This is because as the rate of inflation increases, money devalues in real terms. For example, you can't buy as much with £5 today as you could 30 years ago.

Inflation causes a purely cash investment to devalue over time. So ideally, any investment you make must beat the rate of inflation to grow your money in real terms.

Interest rate risk

This type of risk affects cash savings and inversely affects bonds.

Banks and building societies will increase or decrease the interest they pay on deposits in line with the Bank of England's rates. So if interest rates are low, your cash savings in a bank or building society may not grow very much.

Bond prices move in the opposite direction to interest rates. When interest rates go up, the fixed payments offered by bonds look less attractive. But if interest rates are low, the fixed payments look more attractive and may be more than you might get from your bank or building society.

Market risk

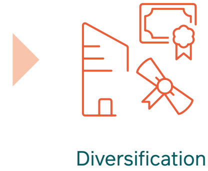
Market risk can affect all types of investment.

Market risk is the risk of an entire market collapsing rather than just an individual company. This could happen as a result of an economic shock or a major institutional failure that triggers a chain reaction affecting the entire market.

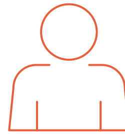
Ways to diversify and manage your risk

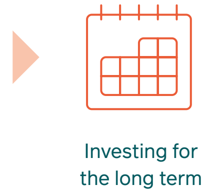
Diversification

Quite simply, don't put all your eggs in one basket. A diversified portfolio that includes higher risk investments, such as equities, as well as lower risk investments, such as bonds, will help to manage and lower your risk. This is because if the equities in your portfolio are volatile and dramatically decrease in value, the fixed interest from your bonds should still give you a regular income and help to give your investment an overall consistent level of performance.

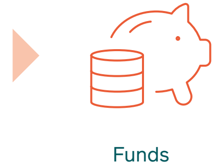


Diversification





Investing for the long term



Funds

Investing in funds

By investing in a fund rather than an individual company, your money is spread across shares or bonds from many different companies, sectors and, in some cases, regions. The risk to the overall investment is reduced since you are not relying on the fortunes of a single entity. If one company in the fund underperforms, the others could cushion the blow.

The cost of investing in a fund can often be less than buying shares or bonds one at a time. This is because the costs are generally lower, the larger the sums involved. Also, an experienced fund manager can select and manage those assets on your behalf.

Investing for the long term

While the value of equities may fluctuate month on month, it can increase over a longer time period. Many types of investment take a tumble for all kinds of reasons (see previous section on common types of risk), but if you invest for the long term (10 years or more), it's possible to 'ride out' these short-term fluctuations. But please note, there is no guarantee of future growth in any market or investment type.

The longer you invest, the bigger the potential effect of compound performance on the original value of your investment. Many of you will be familiar with the term 'compounding' from owning cash savings accounts. Compounding refers to the process whereby interest on your money is added to the original principal amount which then, in turn, earns interest. Your investments can benefit from compounding in a similar way, if you reinvest any income you receive, although you should remember that the value of investments will go down as well as up, causing prices to fall as well as rise so you might not get back the amount you put in.

Investing regularly

Investing at regular intervals can also help reduce risk because markets rise and fall all the time. When the market price is low, a greater number of shares or bonds can be bought for the same money. At other times, when the market is high, the opposite is true. If you buy continuously through the ups and downs, the average price of the investment can be lower than if you make one lump sum investment. Of course, when the market falls, the existing investment will be worth less. But, over time, regular investments can help to smooth out the market's peaks and troughs.

- Plan your investments well and you'll also manage your risk well
- Even if you've chosen a portfolio that suits your level of risk and needs, you should review your level of risk and investment goals on a regular basis
- Diversification is the key to minimising your risk

A few final reminders on risk

Don't forget...

Choosing your level of risk is all about the reward you're seeking. Think about your life plans and when and how you'll want a return on your initial investment (capital). Once you've decided this, you'll know what type of risk is right for you.

If you're saving for retirement, for example, you may be willing to take a higher risk earlier in your life for potentially higher returns. This is because even if your investment doesn't perform well, you still have time to make other plans. But closer to your retirement age, you may choose to switch to a lower-risk investment to help protect your capital.

Important note

The value of your investments can go down as well as up so you might not get back the amount you put in. □

- The level of risk that's right for you will depend on your stage in life and your future plans
- If your life plans change, your attitude to risk may change too, so you want a portfolio that's flexible enough to change with you
- Don't forget that not taking enough risk can be as problematic as taking too much risk

Glossary of investment terms

The following are explanations of some of the terms you would have come across in this guide.

Asset Anything having commercial or exchange value that is owned by a business, institution or individual.

Asset class Category of assets, such as cash, company shares, fixed income securities and their sub-categories, as well as tangible assets such as real estate.

Bond A loan in the form of a security, usually issued by a government or company, which normally pays a fixed rate of interest over a given time period, at the end of which the initial amount borrowed is repaid.

Capital Refers to the financial assets, or resources, that a company has to fund its business operations.

Capital growth Occurs when the current value of an investment is greater than the initial amount invested.

Diversification The practice of investing in a variety of assets. This is a risk management technique where, in a well-diversified portfolio, any loss from an individual holding should be offset by gains in other holdings, thereby lessening the impact on the overall portfolio.

Dividends Dividends represent a share in the profits of a company and are paid out to a company's shareholders at set times of the year.

Equities Shares of ownership in a company.

Portfolio A combination of investments held by an investor.

Return The amount of money you'll make from an investment.

Risk The chance that an investment's return will be different to what is expected. Risk includes the possibility of losing some or all of the original investment.

Risk/reward ratio A ratio comparing the expected returns of an investment with the amount of risk undertaken.

Shareholder Someone who owns at least one share in a company – they are part-owner of that company through the shares they have.

Volatile When the value of a particular share, market or sector swings up and down fairly frequently and/or significantly, it is considered volatile.

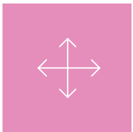
Volatility The degree to which the price of a given security, fund, or index changes. It is calculated as the degree of deviation from the norm for that type of investment over a given time period. The higher the volatility, the riskier the security tends to be.

The M&G guides

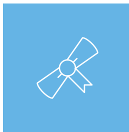
The M&G guides aim to give you the basics about investing, to help you make informed decisions about your financial goals and how to reach them.

We're unable to give financial advice. If you're unsure about the suitability of your investment, speak to a financial adviser. The views expressed in this document should not be taken as a recommendation, advice or forecast.

This brochure is part of our range of M&G guides:



Investing



Bonds

Equities

Risk

Multi-asset investing

Income

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