

Understanding Investment Risk

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If you want to plan for your financial future, it helps to understand risk. If you understand the risks associated with investing and you know how much risk you are comfortable taking, you can make informed decisions and improve your chances of achieving your goals.

Risk is the possibility of losing some or all of your original investment. Often, higher risk investments offer the chance of greater returns, but there's also more chance of losing money. Risk means different things to different people. How you feel about it depends on your individual circumstances and even your personality. Your investment goals and timescales will also influence how much risk you're willing to take. What you come out with is your 'risk profile'.

Different types of investment

None of us like to take risks with our savings, but the reality is there's no such thing as a 'no-risk' investment. You're always taking on some risk when you invest, but the amount varies between different types of investment.

As a general rule, the more risk you're prepared to take, the greater returns or losses you could stand to make. Risk varies between the different types of investments. For example, funds that hold bonds tend to be less risky than those that hold shares, but there are always exceptions.

Losing value in real terms

Money you place in secure deposits such as savings accounts risks losing value in real terms (buying power) over time. This is because the interest rate paid won't always keep up with rising prices (inflation).

On the other hand, index-linked investments that follow the rate of inflation don't always follow market interest rates. This means that if inflation falls, you could earn less in interest than you expected.

Inflation and interest rates over time

Stock market investments might beat inflation and interest rates over time, but

you run the risk that prices might be low at the time you need to sell. This could result in a poor return or, if prices are lower than when you bought, losing money.

You can't escape risk completely, but you can manage it by investing for the long term in a range of different things, which is called 'diversification'. You can also look at paying money into your investments regularly, rather than all in one go. This can help smooth out the highs and lows and cut the risk of making big losses.

Capital risk

Your investments can go down in value, and you may not get back what you invested. Investing in the stock market is normally through shares (equities), either directly or via a fund. The stock market will fluctuate in value every day, sometimes by large amounts. You could lose some or all of your money depending on the company or companies you have bought. Other assets such as property and bonds can also fall in value.

Inflation risk

The purchasing power of your savings declines. Even if your investment increases in value, you may not be making money in 'real' terms if the things that you want to buy with the money have increased in price faster than your investment. Cash deposits with low returns may expose you to inflation risk.

Credit risk

Credit risk is the risk of not achieving a financial reward due to a borrower's failure to repay a loan or otherwise meet a contractual obligation. Credit risk is closely tied to the potential return of an investment, the most notable being that the yields on bonds correlate strongly to their perceived credit risk.

Liquidity risk

You are unable to access your money when you want to. Liquidity can be a real risk if you hold assets such as property directly, and also in the 'bond' market,

where the pool of people who want to buy and sell bonds can 'dry up'.

Currency risk

You lose money due to fluctuating exchange rates.

Interest rate risk

Changes to interest rates affect your returns on savings and investments. Even with a fixed rate, the interest rates in the market may fall below or rise above the fixed rate, affecting your returns relative to rates available elsewhere. Interest rate risk is a particular risk for bondholders.

Seek Professional Advice

It's important to make informed decisions to improve your chances of achieving your financial goals.

Speak with one of our independent financial advisers to discuss your financial goals.

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