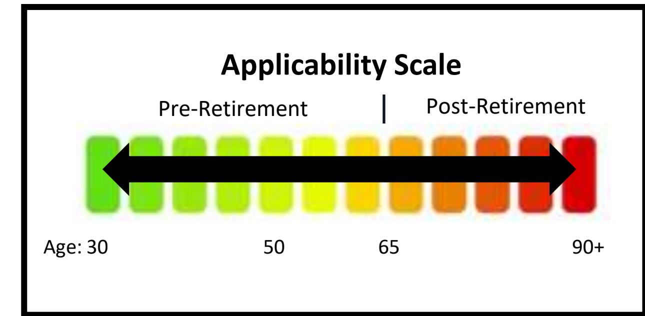

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TOPIC: Understanding Risk

Understanding Risk

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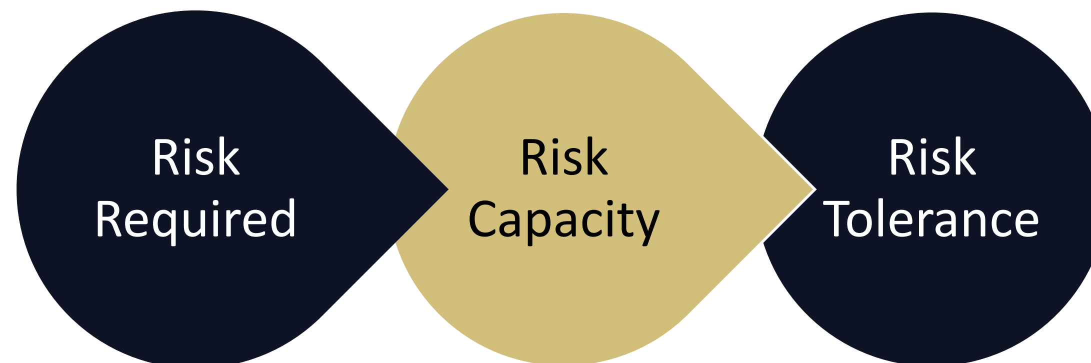
- When looking at risk and how it relates to individuals and their finances, there are three types of risk that need to be considered.
- **Risk Required** – this is how much risk you are required to take in order to achieve your goals. Think of a person who has 30 years until retirement, the risk they **need** to take in order to accumulate enough for retirement, is low, as they have time on their side. On the other hand, someone who is 5 years away from retirement and has insufficient funds **needs** to take a lot more risk in order to get as big a return as possible in the short term.
- **Risk Capacity** – this is how much risk you can afford to take. If the money you are wanting to invest is your life savings, most people would prefer to be more cautious. If the money you wish to invest is a small portion of a bigger pot, then you have the capacity to take on more risk if you wish.
- **Risk Tolerance** – this is how much risk an individual is comfortable taking. This is more of a personal preference. Some people by nature are very cautious, others are more aggressive whilst most people hover somewhere in the middle.
- Understanding the careful balance and inter-play between these three risk factors is critical to ensuring you make sound financial decisions that you won't regret later.



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Factors that affect Risk

- **Objective –** When investing, you need to know exactly for what purpose you are doing this. Is it to create more wealth, save for retirement, assist with your children's education or maybe to produce a reliable income? You must be clear as to the objective of the investment.
- **Age –** Unfortunately we do not know how long we will live, however it is commonly accepted that the older you get the probability of passing on increases. It is therefore important to ensure that your goals are realistically aligned to your age. If older clients wish to continue investing in high risk products, then your adviser has a responsibility to explain the risk and the impact it could have if things don't go according to plan.
- **Timeframe –** You need to understand when you wish to receive benefit from your investments, as long-term funds have to be structured very differently from short term ones. Most goals fit into one of the three categories —short, medium or long-term.
- **Access to cash –** It is important to know, that before making any investment decisions, you have enough excess cash (or access to it) should something go wrong. Some people make successful investments only to have an emergency a year down the line and are limited or have no access to funds to remedy the situation. Therefore you need to know if your investments are "liquid" (easy to convert to cash).
- **Income –** If you are looking for an investment to return an income for you, it is important for your adviser to know how much income you currently receive and whether this is likely to change significantly in the future. Additionally you need to tell your adviser should you foresee your future income requirements changing. Without this information, you cannot plan effectively.

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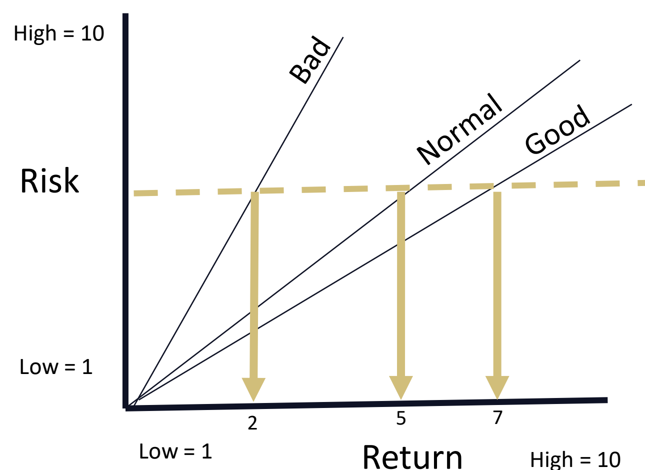
What do the 3 risk Metrics mean?

- When you speak to your financial adviser, you need to understand that he has a very tricky job as he needs to balance the three types of risk in order to achieve your financial goals. In some instances, you have people who have to take on a lot of risk if they are to achieve their goal (risk required). They may even be happy to take on this high risk (risk tolerance), however they do not have the means (risk capacity) to do so.
- It is important therefore to understand the relationship between risk and return. Most people want very high returns but aren't prepared to take on any risk. Most of the time there is a direct correlation between risk and return. The higher risk we take, the higher the return we get and conversely, the lower the risk we take, the less the return we achieve. Your Financial adviser is however constantly looking for investments where this relationship is skewed in favour of higher returns with lower risk.



- To understand this graph let's assume we are prepared to take a risk of 5 out of 10 (indicated by the dotted horizontal line). In a normal scenario, this would mean we can expect a return of 5. Sometimes however, in good scenarios, you can take the same level of risk but potentially return a 7, or conversely, in a bad investment, receive a return equal to 2.

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Financial Risk & Return Indicators

- There are a number of very fancy terms that you hear bandied about by investment professionals, that for most people make no sense whatsoever. However, if you do understand them, they can be very useful in helping to select quality investments. So with this in mind, let's review two of the most commonly used ones.
- **Sharpe Ratio** – This ratio compares the return of an investment and divides it by the risk. Usually, a Sharpe ratio greater than 1.0 is considered acceptable to good by investors, whilst a **ratio** higher than 2.0 is rated as very good, and a **ratio** of 3.0 or higher is considered excellent. Understanding this, you can now look at fund fact sheets and know whether you are looking at an investment that is normal (i.e. around 1), bad (less than 1) or good to very good (above 2).
- **Beta** – This ratio measures the risk that is inherent or unavoidable in the market or sector in which you are investing and compares that to how your specific investment has performed. Basically it's a measure of volatility. If your investment has a beta of 1, this indicates it has the same amount of risk present in whatever market or sector you are investing. If it is greater than 1, then this indicates it's riskier than other opportunities in the same market or sector. Lower than 1, means the investment is less risky.
- Therefore, investments that have high Sharpe Ratios above 2 and Betas of 1 or less are likely to give better returns with lower risk, however in the investment world nothing is ever 100% certain!

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