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Risk Disclosure

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Risk disclosure

Risk and what it means to you

It's difficult to plan financially without some understanding of investment risk.

Many people, when they hear 'risk', think automatically about the chance of being defrauded or not getting all of their money back. This 'capital' risk is important, but it isn't the only type.

Other types of risk involve uncertainty and unpredictability. When you make an investment, it can be difficult to say with any certainty what you'll get back when you cash it in at any particular date in the future. Share prices fluctuate, interest rates vary and inflation is a risk too.

Just concentrating on capital risk and ignoring these other risks can mean you take too cautious an approach.

Understanding risk helps you manage your own attitude towards it and should help you make better investment decisions.

A definition of investment risk

Investment risk is defined as the volatility associated with returns on investment and is indicative of the potential for both losing and making money. So whilst the concept of risk may sound negative and you might associate it with loss, it can also mean that returns are unexpectedly high.

The nature of investing means that an investor can never know exactly what level of return they will make. This is what risk is, it is the fact that you don't 100% know how much your money will be worth on a specific date. Different investments carry different levels of risk.

Different levels of risk

When putting capital into a higher-risk investment, like equity, you can expect to have a more volatile journey. However, a high-risk investment may also give stronger returns in the long term as the effects of risk diminish over time.

This means that individuals who want to significantly increase the value of their investments are more likely to opt for high-risk investments, and as such will accept that their efforts could fail. Similarly, those who can invest for a longer period are able to accept higher levels of volatility along the way.

Conversely of course, if your time horizon is short, it's wise not to take too much risk.
Low-risk investments, like Government bonds, have a lower return potential but are generally more steady. Every investment however, comes with some sort of risk, and no single asset class can be depended upon to produce consistent returns in all conditions.

Different types of risk

As well as the different levels of volatility investors will encounter, there are also a number of different types of risk that it is important to know about when investing.

- Inflation risk is relevant for those who leave a sum of money in a cash savings account. Whilst the amount of money they have won't decrease, their buying power might, if the rate of inflation is higher than the interest rate received. The Bank of England currently targets 2% inflation.
- Market risk constitutes the rise or fall of the stock market in the country where an individual's money is invested. If a benchmark index falls, the vast majority of shares will be dragged down with it. These are the movements associated with volatility.
- Interest rate risk refers to when an individual puts their money in a fixed-rate deposit account. If savings rates rise, they could end up gaining less interest than the market average. However, if savings rates fall, they could be getting more beneficial rates. Interest rate movements can also affect bond price movements.
- Capital risk comes into play given the fact that the higher the investment returns an individual wishes to receive, the higher risks they must be willing to take. However, this also means you run the risk of your capital falling significantly. With start-up companies for example, some may experience spectacular growth, but others may fail completely. This type of risk can be overcome by diversification – not putting all your eggs in one basket.
- Performance risk relates to the difference in performance between investment funds with similar objectives, due to the differing selection of assets by each one. Funds that have a high-performance objective will often encounter higher levels of volatility than those with a more traditional investment portfolio. They might diversify less and this alone may cause additional volatility.

How can you affect risk

Whilst much of the volatility of the markets cannot be predicted, how you act as an investor can influence risk.

If you leave your money in cash and do nothing, you risk inflation eating away at the value of your wealth. Those who take a little risk, but not enough, may come up against a shortfall – the risk of failing to meet a long-term investment goal.

At the other end of the scale, investing too frequently and constantly acting on the news of the day, can lead to significant mistakes being made.

As US investor, business magnate, and philanthropist Warren Buffett once said: "We continue to make more money when snoring than when active."

Ultimately, the more decisions you make, the bigger the chance of getting something wrong. Being patient, buying and then holding for the long-term, tends to work well. It also minimises the unavoidable transaction costs, the costs of buying and selling.

The role of emotion in investment

Before starting to build an investment portfolio, it is important that you understand your attitude to risk and can predict how you will react in certain situations.

Those with a high-risk portfolio are likely to experience drops in the value of their investments from time to time, but to reap the long-term rewards, it is vital that they hold their nerve. Some people will be happy to absorb these risks in exchange for the likelihood of higher returns, whereas others would be very unsettled by the news of their value falling.

Furthermore, if you're the sort of person who is cut out for high-risk investing, you're likely to be disappointed with a low-risk portfolio that doesn't give the opportunity to deliver the returns you want.

How accepting you are of higher risks is not just down to your character; the source of the money you are planning to invest can be another factor. For example, if your investment is funded by your life savings, you might be more protective of this money than if it came from a windfall you didn't expect to receive in the first place.

Keeping appropriate levels of cash in reserve will avoid you having to cut-short a long-term investment plan and may also allow you to feel more comfortable about the volatility of your longer-term investments.

Cryptocurrency specific risk

Cryptocurrency is a digital representation of value that functions as a medium of exchange, a unit of account, or a store of value, but it does not have legal tender status. Cryptocurrencies are sometimes exchanged for British Pounds, U.S. dollars or other currencies around the world, but they are not currently backed nor supported by any government or central bank. Their value is completely derived by market forces of supply and demand, and they are more volatile than traditional currencies.

Investing in cryptocurrencies comes with significant risks, including volatile market price swings or flash crashes, market manipulation, and cybersecurity risks. In addition, cryptocurrency markets and exchanges are not regulated with the same controls or customer protections available in equity, option, futures, or foreign exchange investing. Cryptocurrency investing requires knowledge of cryptocurrency markets. In attempting to profit through cryptocurrency investing, you must compete with investors worldwide. You should have appropriate knowledge and experience before engaging in substantial cryptocurrency investing.

Investing in cryptocurrencies may not generally be appropriate, particularly with funds drawn from retirement savings, student loans, mortgages, emergency funds, or funds set aside for other purposes. Investing in cryptocurrencies can lead to large and immediate financial losses. Under certain market conditions, you may find it difficult or impossible to liquidate a position quickly at a reasonable price. This can occur, for example, when the market for a particular cryptocurrency suddenly drops, or if trading is halted due to recent news events, unusual trading activity, or changes in the underlying cryptocurrency system. Several agencies have also published advisory documents surrounding the risks of virtual currency.