Our guide to Understanding Investments and Risks

TrinityBridge

At TrinityBridge, we want to do all we can to help you invest successfully.

We believe all investors, irrespective of size, are looking for an optimum mix of investments that will preserve and increase the value of their wealth over time. We feel the best way to achieve this is through a diversified, multi-asset portfolio that can perform across a range of market environments.

Whether you are an experienced investor able to make your own decisions; an intermediate investor who wants some help making your selection; or a new investor who wants to understand the basics of investing before seeking professional advice, we are here to help.

About this guide
This guide will explain what you should think about before making any investment.

It cannot provide specific advice or guidance, but it will set out the things you need to consider when investing so you can make the right decisions.

If you think you would benefit from individual advice, our friendly experts are ready to help.

The guide is split in to the separate steps that will make up your own, individual investment journey. These are:

- Do I need professional advice?
- What am I investing for?
- How long do I need to invest for?
- Lump sum or regular savings?
- What risks are there to investing?
- How much risk am I willing, and able, to take?
- Can I reduce the risk I take?
- How do I select my investments?

Do I need professional advice?
Ask yourself the following questions:

- Do I have a good knowledge of investments?
- Do I enjoy reading about investments and doing research?
- Do I have the time to monitor and evaluate my investments and make periodic changes to my portfolio when required?
- Am I comfortable with the fact that I will be wholly responsible for the way my decisions turn out?

If you are not sure that you understand the risks of investing, or how to get the right balance of risk for the return that you need, you should seek professional financial advice. You should also consider getting advice about the effect of tax on your investments and your broader financial arrangements. Although there is a cost to taking advice, you will benefit from the knowledge of experts who can help you make the right decisions.

What am I investing for?
What do you want from your investment? Do you want to grow a lump sum for your retirement; buy a car or a house; save for university fees, or treat yourself to the holiday of a lifetime? Do you need an income from your investment to help you in your retirement, or supplement your earnings from other sources? Do you need income and growth together?

Understanding what you want your money to do for you is the first step when thinking about investing, and it will help you find answers to all the following questions.

How long do I need to invest for?
The length of time you are investing for is critical in deciding which investments to make and what risks you are willing to accept. Generally, if you intend to hold your investment for a longer period you can consider higher risk, higher return investments such as equities (shares) and funds. Although there are investors who actively trade investments over short periods, the general wisdom is that you should plan to invest for a minimum term of five years when investing into traditional equity style funds. The value of these investments can vary significantly, especially over the short term, so a longer time horizon is sensible in order to smooth out the effects of market volatility.

Please also be aware that if you are investing a small amount regularly, it may take some time to build up a useful lump sum.

If you intend to hold your investment for a short period of time, or there is a risk that you may need to sell your investment at short notice, you should consider investing in less volatile assets or holding your investments in cash. If you plan to invest for less than five years, then ensure that you fully understand the risks involved in the investment (though you should do this with any investment), and also consider funds that:

- Offer more stable returns.
- Allow you to withdraw without any exit fees or penalties.

Lump sum or regular savings?
How much to invest – and when – depends on your individual circumstances, the affordability of the investment and how much risk you are willing to take.

If you have confidence in your investment choice and are comfortable with the risks involved, you may want to invest a lump sum. This means you pay the same price for all of your investment and will participate in the full ups and downs of its value.

However, if you don’t have enough put aside (some investment funds, for example, may require a minimum lump sum investment of £1,000), or are worried about making all your investments in one go, you might prefer to invest your money gradually over time. This has the effect of smoothing out changes in the price of the investment, and removes the worry about investing all your money at the wrong time – right before a market fall, for example.

What risks are there to investing?
It is a basic fact of investing that risk and reward go hand-in-hand. The greater uncertainty, or risk, we are prepared to accept, the greater the potential for higher returns on our investment but also the greater potential for loss.

However, it is important to understand that no investment is risk-free. Only when you understand the different type of risks that apply to different types of investment can you answer the question, ‘How much risk am I prepared to take?’.

Below are details of the main risks that apply to investments. With thousands of different investment opportunities available, the list cannot be exhaustive. You must ALWAYS thoroughly read and understand the literature that accompanies an investment. In it you’ll find details of the nature, the commitment required, and the risks and potential benefits of the investment.

Risk of loss
If you buy any investment, be it a fund, an equity or bond, there is no guarantee that you will get all of your money back when you decide to sell. Generally, the lower the risk, the lower the potential return that you can expect. If your objective is to grow your investment in value then you will have no choice but to accept a certain degree of risk.

Volatility
This is not a risk in itself, but a measure of how much the value of an investment goes up or down over a certain period of time. The more volatile an asset is, the more the price will change. The obvious risk is that you buy an investment while the price is high and sell it when the price is lower.

The credit crunch of 2008 showed how volatility can affect returns; many investors did not receive the value they were expecting as the price moved so quickly. Equally, more volatile investments can also have the potential to generate the greatest return.

An investment that is designed to give a fixed return, such as a cash deposit, will have the least volatility, whereas an equity, where the price is determined by market sentiment, will generally be more volatile. Equity values can change dramatically following individual events, and tend to be the most volatile. For example, a small mining company that suddenly strikes oil could experience a big jump in its share price – but if it only finds water, investors may sell their shares, causing the value to plummet.

It is important to recognise that past performance is not a reliable measure of volatility; an investment may have a steady price for some time and then suddenly increase or decrease in value. For example, a bond issued by a company may have a steady value until news emerges that the company might not be able to repay its debts, at which point the value of the bond will suddenly fall.

Counterparty or credit risk
Even when you invest in a bond or a cash deposit that appears to guarantee that you will not lose any money, there is a risk that you could, if the company that you are effectively lending money to is unable to repay its debts.

For example a bond may offer a 'guaranteed' return of capital invested but it may not be able to do so if the company that issued the bond becomes insolvent. Some products invest money in a combination of bonds and derivatives so that, ordinarily, they will return all of the capital invested; but these could still leave your money at risk if the company that issues the bond or the derivative fails.

Inflation risk
This is the risk that your money will not buy as much in the future as it does now, due to the effect of inflation on the price of the goods that you want to buy.

All investments are subject to inflation risk. And although keeping your money in a bank savings account may give you more certainty of return, ease of access and greater security, it increases your exposure to inflation risk because the returns may be lower than the rate of inflation.

To illustrate this with numbers, if inflation is four per cent a year then your investment return needs to be greater than four per cent otherwise you are reducing the purchasing power of your cash. If the return on your investment is only three per cent then your money is losing one per cent of its purchasing power in real terms – and over time, this can have a significant impact. The effect is compounded if you also have to pay tax on your investment.

Fixed term risk
Some investments require you to hold them for a fixed period of time, or give notice before you withdraw them, for example, a three year fixed term deposit must be held for three years.

So fixed term risk comes in two parts: opportunity risk, where you may find that you could earn a higher return from another investment but cannot do so because your money is "locked up"; and the risk that a change in your circumstances could force you to withdraw your investment. This might not be possible, or could involve significant financial penalties.

Marketability risk
In some circumstances, there may be no buyer available when you wish to sell your investment. This is a greater risk when you invest in smaller companies whose shares are not traded as much as those of larger companies and there is lower investor demand. It is also a risk with some bonds and structured products where there may not be a ready market.

Marketablity risk can result in a sizeable difference between the buying and selling price of an investment. It may also be more difficult to get accurate information about the value of the investment and there may be no recognised markets for funds if the units or shares are issued and redeemed solely by the manager or operator of the funds. The fund may not be available for purchase or sale every day, especially at times of exceptional market volatility, and trading in the fund might even be suspended if the manager does not believe that they can allow the redemption of units without disadvantaging the remaining holders.

Concentration risk
This risk occurs when you have too much of your money concentrated in one area, for example all in one particular stock or all in one industry or sector which could all fall in value at the same time, as a result of a single event.

Currency exchange risk
Currency exchange rates are constantly fluctuating and can change the value of your investments irrespective of its underlying value. If you invest in an asset that is priced in a currency that is different to your base currency, the volatility of the exchange rate will add to the volatility of the asset.

For example, if you buy a Dollar-priced fund using Sterling, the movements in the exchange rate will have an impact on the investment return. If the price of the fund has increased by five per cent, a rise in the value of Sterling against the Dollar will undermine this performance. Likewise, a fall in the value of Sterling, would amplify the performance.

How much risk am I willing, and able to take?
Once you understand the risks associated with investing, you need to evaluate your attitude to those risks. How much risk are you prepared to take, given your investment objectives, and would you be able to accept the consequences if those risks were to materialise? Would you have time to make other arrangements, or be able to wait for a recovery in price?

How would you feel if you were to lose some or even all of your money? It may be that you can afford to lose it in financial terms, but it could still upset you and those around you.

You should consider not only your attitude to risk, but also that of your dependants and beneficiaries, as this could be very important if you were to die or become incapacitated.

You should also consider what other investments you have, and your experience of investing. You can be more confident about taking significant investment risks if you have had experience in the past of the effects of falling asset prices and capital loss.

Can I reduce the risk I take?
You can take steps to make sure your portfolio of investments is constructed in a way that reduces your investment risk. A good starting point is diversification.

Diversification
There is an old saying: ‘never put all your eggs in one basket’. Holding investments in several types of assets, across separate industries and different countries, is an important way of reducing investment risk. The values of individual assets may be volatile, but by investing in lots of different assets the specific risk involved in any single investment is more widely spread.

It is important to diversify not only between different assets but also different types of assets; investing in several different oil companies will reduce the risk of the impact of an individual company failing to strike oil but will not reduce the risk of volatility as a result of changes in the price of oil. Investing in funds is a good way to achieve diversification because even with a relatively small investment of £1,000, you are still getting exposure to a broad spread of underlying investments.

Correlation
Correlation is the extent to which the values of investments all move in the same direction (and even by the same amount) in reaction to events. For example, a portfolio may be diversified across different types of companies in different sectors of the economy, but their values might all fall in reaction to a recession.

An important strategy to reduce investment risk is to invest in assets whose values react in a different way to external events. For example, the value of shares in manufacturing companies might fall in reaction to news of global economic slowdown, but at the same time the price of gold might rise as investors move their money into a safer haven. These two asset classes are said to be 'negatively correlated' in respect of this event because their values go in opposite directions.

Using funds to diversify risk
If you invest in a general fund, make sure the fund manager has selected a diversified set of investments that have low correlation to each other.

If you invest in funds that have an exposure to a specific asset class or sector, it is important to invest in a number of different funds to diversify your investments and reduce your investment risk.

Whether you choose general or specialist funds, investing in a number of different funds will reduce the impact on your portfolio if a particular manager underperforms.

Timing of investment and withdrawal
The performance of your investment will ultimately depend on the cost of your investments when you buy them and the price you get when you sell them. To reduce the impact of volatility on the performance of your investments, you should look to invest and withdraw your assets over a medium to long period of time.

What if things change?
You may be very clear about your investment objectives today, but you should also consider the likelihood of those objectives changing over the life of your investment.

You should consider the possibility that you may lose your job or other sources of income and the potential for an emergency or disaster that could require you to change your plans.

You should consider the possibility that you could die, or become incapacitated, during the term of your investment. In this case the investment objectives of your dependants or beneficiaries will become more important.

You should also consider the impact of inheritance tax on your investments if you were to die. Some types of investment can reduce the impact of inheritance tax; you should seek financial advice if you need to understand more about this.

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