

Investments and risk

Investment is a fairly straightforward concept; the aim is to grow your assets while taking an amount of risk with which you are comfortable. There are many different types of investments, and when choosing which is the most appropriate you should always think about how much risk you are prepared to take. Your risk appetite is a very personal thing, and depends on factors such as your age, circumstances, financial goals and time horizon. Are you a natural risk-taker, or do you prefer the 'sleep at night' reassurance that lower risk investments are more likely to offer? If you are investing for the long term, you may be prepared to take on more risk and ride out peaks and troughs in returns along the way. For an investment in a child trust fund, for example, given the age of the person on whose behalf you are investing and the likely 18-year timescale, it may be appropriate to go for something towards the higher end of the risk scale. If, however, you are only a few years from retirement, a more cautious approach probably makes more sense.

What is the risk?

Risk can mean different things to different people. Some view it as the risk of losing money. For others, it is the risk of not making enough money to meet your needs. All investments involve some level of risk. At the lowest end of the risk scale is cash. Putting your money into a bank or building society account is just about the safest way of investing, although even here the real rate of return is dependent on inflation and whether interest rates rise or fall. Generally, unless the bank goes under, you will not get back less than you put in, although returns are always likely to be lower than those from other asset classes.

Investing in shares

Potentially much more risky is investing in the shares of individual companies. Companies' share prices are ultimately driv-

en by their profitability, but can also be subject to situations over which they have little control. A piece of bad news concerning a business in the same industry, or more widespread stock market nervousness, can send a company's share price tumbling. Rather than buy an individual equity, a safer way of company investing might be to invest in a fund which reduces risk by holding a diversified portfolio of companies. There is any number of funds right across the risk spectrum, encompassing different geographical regions and investment themes. And if you can not decide which fund to go for, there are even funds of funds.

Other investment options

The other major asset classes in which people generally invest are fixed income, otherwise known as bonds, and property. Bonds take two main forms: gilts, which are issued by the government, and corporate bonds, which are issued by companies. As with all investments, there are different levels of risk involved. A UK government bond would be at the lower end of the risk scale, whereas corporate bonds vary according to the company that is issuing them. Just like shares, a good way of investing in bonds is via a fund, where again the risk can be diversified.

Property has always been popular with investors. Over time bricks and mortar tend to go up, although there are periods when that's not the case. Buy-to-let was all the rage a few years back but when the residential property market slows down, as it has recently, investors are typically unable to achieve the same returns. The same applies to commercial property.

Risk and reward

Historically, risk and reward have been shown to be closely related – the more risk taken, the greater the potential reward. Shares generally produce the best returns over time, but with more volatility along the way. Cash is much less risky but with associated lower returns. Barclays Capital's Equity Gilt Study 2007 provides data on the annual returns from equities, government bonds and cash in the UK going right the way back to 1899. Over the entire 107-year period, the real return (i.e.

less inflation) from equities was 5.3% on an annualized basis against 1.0% for cash. The study also shows that over a 10-year period there is a 93% probability of shares outperforming cash, and an 83% probability of them outperforming gilts. Over longer periods these figures are even higher. Volatility of returns also reduces considerably over time. However, past performance is not a guide to future performance.

Diversification

A key word to consider when thinking about investments is diversification. Diversification is an effective way of reducing risk across different asset classes and across a range of investments within each. The returns from shares, bonds, property and cash are not correlated – they perform differently in different market conditions – hence spreading your investments across some or all of them means that if one performs badly another may perform well during the same period. A large number of managed funds are available, which effectively create just such a portfolio for you. Usually split into the categories of active, balanced and cautious managed funds, these are spread along the risk scale to allow the investor to pick the one most suitable for them.

Different types of products come and go, and some do not always work as they were intended. With profits funds, for example, aim to smooth returns using bonuses. When stock markets fell sharply a number were unable to maintain this strategy, however, some in the market place continue to smooth returns very successfully. The providers' financial strength is critical in their ability to do this. New products also appear as providers find ever more innovative solutions. Various wrappers such as insurance bonds can be used around products, most commonly for tax purposes. But ultimately the main asset classes remain the same. The choice investors face is how much risk they want to take on and therefore how best to divide their investments between these asset classes. **BJHM**

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