EValue

Powering financial insight

HOW TO... COMMUNICATE THE IMPACT OF RISK TO YOUR CLIENTS

How to Guide from EValue

INTRODUCTION

In the second of our 'How To' series for advisers we will consider the subject of risk and the central role it plays within the investment advice and recommendation process.

The following 9 steps highlight the method for helping your clients understand the impact that investment risk can have on their assets and future returns.

We will begin by thinking about different objectives a client may have for their investments and how they may have different views on the amount of risk they are prepared to take with each one. We will then look at what risk is and whether it is possible to avoid it. Finally we will consider how risk impacts different investment outcomes.

STEP 1: CONSIDER CLIENT OBJECTIVES

The first point to consider when communicating the impact of risk on investments to clients is to understand their goals. Various pots of money owned by the client may be required for different reasons and have separate time horizons.

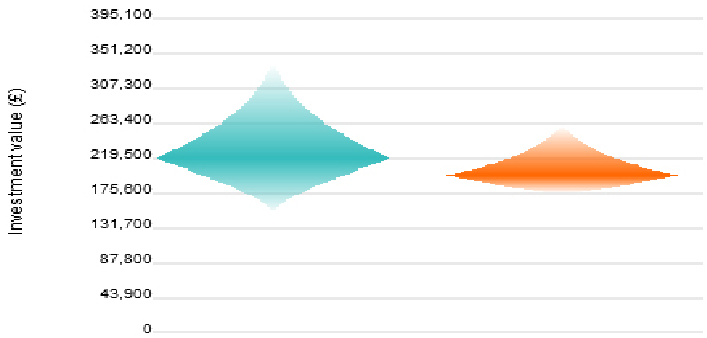
A good example of this is when a client is saving towards retirement in 30 years' time and also putting money aside for their children's education in 10 years' time. Here there are two distinct goals that need to be addressed differently. Part of that discussion should be to agree the client's risk profile for each objective. It could be, for example, that they are prepared to take a more adventurous approach towards their longer term retirement goal than for the immediate goal of paying for school or university fees.

The client needs to understand the impact of taking a different approach to these goals, both the potential positive and negative effects!

STEP 2: UNDERSTAND WHAT RISK IS

A dictionary defines risk as exposure to the chance of injury or loss; a hazard or dangerous chance". In investment terms it is hoped that no physical injury will be suffered as a result of a recommendation! However, the possibility of making a loss should be taken into account.

Investment forecast based on level of risk taken

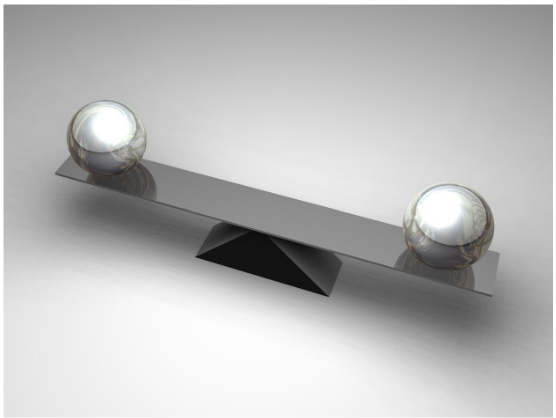


Investment risk is about the possible range of returns (from low to high) from an investment over time.

This diagram illustrates that, for a given investment, there is a range of possible outcomes at the end of the term. A higher risk investment (as seen on the left of the diagram) will have greater highs and lows than a lower risk investment such as the one on the right.

STEP 3: EXPLAIN THAT EVERY CHOICE INVOLVES RISK

MANAGING RISK IS A BALANCING ACT



If we think about the above definition of risk in the context of life in general, can anything be thought of as being risk free? If, for example, we chose to stay in bed all day, certainly we would avoid the risk of being run over by a bus. On the other hand, the risk of attracting bed sores will increase! In life, as with investments, there is no such thing as a risk free environment - decision making is all about understanding and being comfortable with the level of risk being taken and then managing it as best as possible to keep below the risk tolerance level.

STEP 4: ESTABLISH WHAT IS ACCEPTABLE TO YOUR CLIENT

Where you are making an investment recommendation to a client you are potentially exposing them to investment risk. It is important to understand:

- the type of investment risk being experienced and
- the extent to which risk is acceptable to them

You will establish the extent (or amount) of risk a client is able and willing to take by completing your risk profiling process, which is likely to include (amongst other considerations):

- an attitude to risk questionnaire and
- additional capacity for risk questions

Attitude to risk confirms a client's willingness to take investment risk. Capacity for risk records how much risk they are able to take, based on their personal circumstances. These may include on-going financial commitments or perhaps other individuals, such as children, who are financially dependent on the client. The result of a capacity for risk discussion may be that their final risk profile is different from that indicated by their attitude to risk questionnaire.

STEP 5: DISTINGUISH BETWEEN DIFFERENT TYPES OF INVESTMENT RISK

There are several types of potential investment risk.

If you were to ask a client what they consider investment risk to be, it is likely that they would tell you it is the chance they will lose their money. By this they probably mean they will get back less than they invested.

However, what if the monetary amount either stays the same or rises a little, but the rate by which inflation rises exceeds the amount of interest earned by the investment? Your client will be unable to buy as much with their money in the future as when they invested it. So, isn't this losing money too?

Any discussion about investment risk therefore needs to be clear about the type of risk in question. The following is a list of the main types of risk associated with investments:

Market Risk - the risk that there might be a reduction in expected returns across a whole market;

Specific Risk - the risk that there might be a reduction in expected return as a result of some event or circumstance specific to a particular company;

Currency Risk - investing in overseas opportunities can be affected by fluctuations in exchange rates;

Shortfall Risk - the risk of a set target for an investment not being reached (e.g. missed loan repayment);

Default Risk - the risk that the issuer of the investment will collapse and fail to pay interest or repay capital;

Liquidity Risk - the risk that the investment is difficult to sell or encash (e.g. a property);

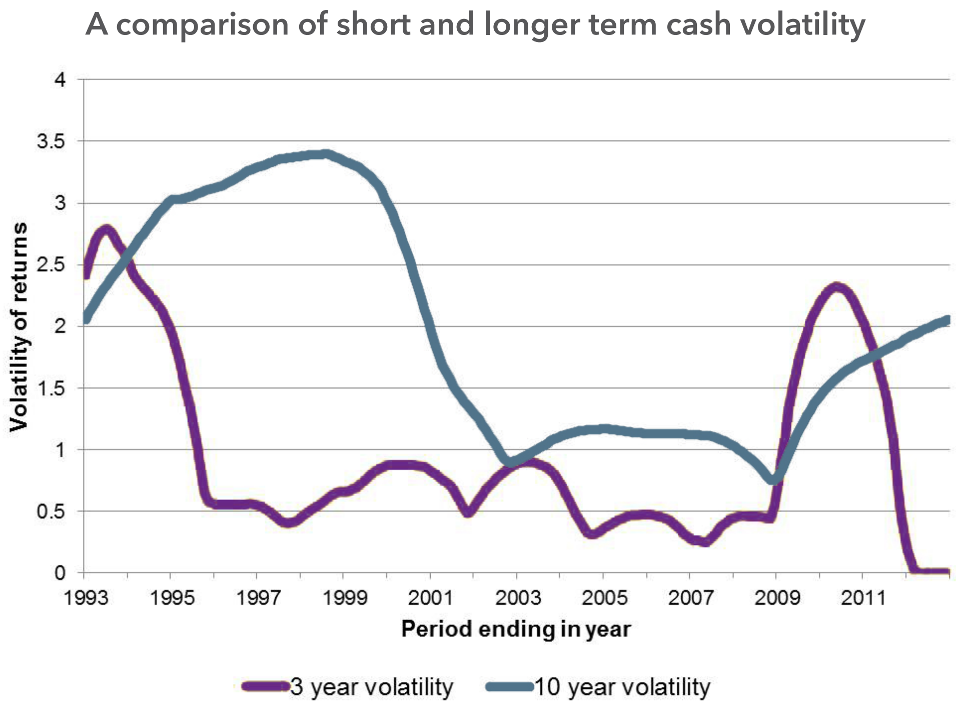
Inflation Risk - the effect of rising prices on the true value of an investment.

STEP 6: UNDERSTAND WHY ASSETS BEHAVE DIFFERENTLY

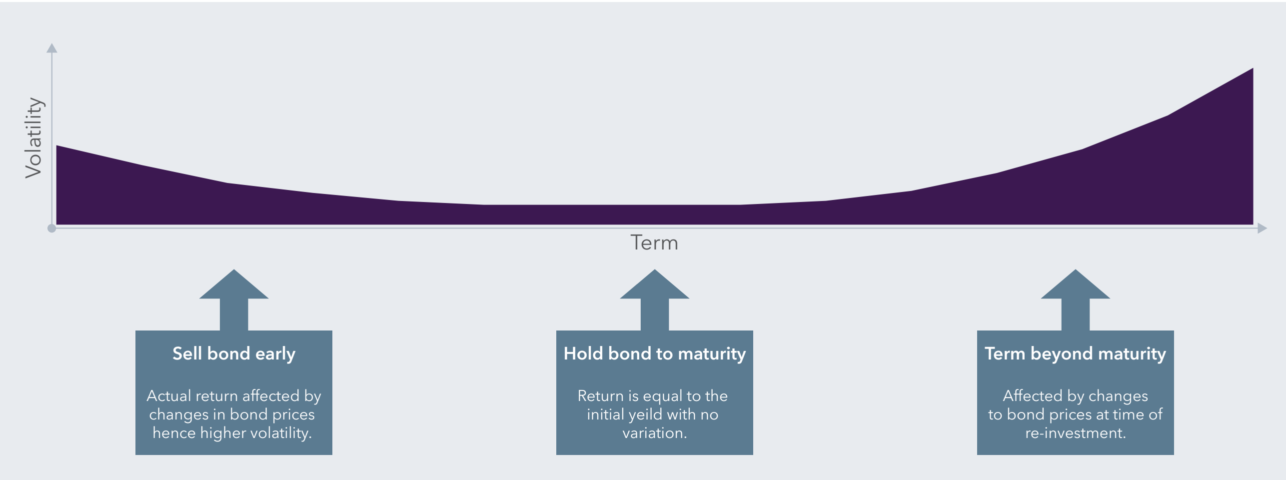
Once we have established the type and extent of risk that a client is prepared to take, it is necessary to appreciate how the risk level of assets can vary over time.

Let's consider an example that is not connected to financial planning and imagine that we have bought a carton of milk and a bottle of red wine today from our local supermarket. It is quite clear that the milk will be at its freshest and therefore, most drinkable, if it is consumed immediately. If left for more than a few days, particularly if not refrigerated, its quality will reduce to a point at which it is undrinkable. Red wine, on the other hand, although also immediately drinkable, is likely to improve in quality for a long time into the future.

Similar comparisons can be made between the risks of different asset classes when investment advice is being given. It is generally considered that cash is a 'low risk' investment. But let's look at this in more detail. The diagram below represents the volatility of cash over 3 and 10 year periods ending during the past 20 years. It shows that, with just one exception, 10 year volatility has been higher than 3 year volatility. This highlights that, over longer time frames, the volatility of cash increases.



Another interesting asset class to consider here is bonds. Let us take a simple example of a 'no coupon' bond. It is usually bought at a discount, compared with its par (or face) value to compensate the investor for the fact that no coupon (or interest) is payable. It can be held until its maturity date, when the par value is repaid. If however, the investor sells the bond early, its actual return will be affected by movements in bond prices. On the other hand, if it is held beyond the maturity date, it will be affected by any changes in bond prices at the time of re-investment. The impact of all this is that bond volatility can change over time in a 'U' shape, as illustrated below.



STEP 7: EXPLAIN THE IMPORTANCE OF DIVERSITY

We will now consider the behaviour of equities.

It is commonly believed that they are a method of investment that carries a significantly higher risk compared with cash and bonds. And certainly, if only shares in a particular company or sector are held, exposure to risk specific to that company or sector will be high.

Let's take an example of shares in a sun cream company. Performance of these shares is likely to be affected by factors such as the weather. In the event of a poor summer therefore, sales of sun cream could fall, along with the value of shares in the company. An investor who has all their money in this company is, consequently, adopting a high risk strategy.

If, however, this investor also invested in the shares of a Wellington boot company, they are spreading (or diversifying) their investments across different market sectors with the effect of reducing the overall risk of their portfolio.

Diversification can also affect the risk rating of a portfolio where individual funds have the same risk rating. In the example shown below the two funds illustrated have the same risk profile, using EValue's 1-10 risk profile categories. When however, they are assessed together, the overall risk profile reduces. This is because the funds invest in different areas, causing lower levels of exposure in individual sectors of the market. Hence the reason why many individuals invest in multi-asset funds.

The two funds assessed individually are risk profile 7

Portfolio 1	1 2 3 4 5 6 **7** 8 9 10	Henderson UK Property I Acc	100.00%
Portfolio 2	1 2 3 4 5 6 **7** 8 9 10	Pru Balanced Portfolio A Acc	100.00%

When assessed together their overall risk profile reduces to 5

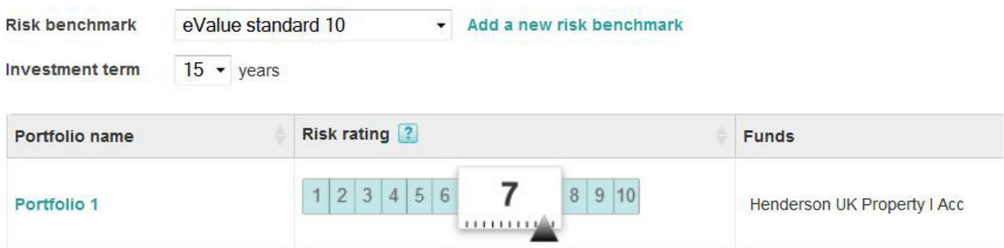
Portfolio 3	1 2 3 4 **5** 6 7 8 9 10	Henderson UK Property I Acc	50.00%
		Pru Balanced Portfolio A Acc	50.00%

STEP 8: CONSIDER THE INVESTMENT TERM

We saw earlier in this guide how assets behave differently over time. This becomes an important factor when making a fund recommendation to a client with a given risk profile and then choose a fund, irrespective of the proposed time horizon for the investment.

In the example below a fund has firstly been risk rated assuming a term of 15 years and then over 25 years. We can see the different results in each case.

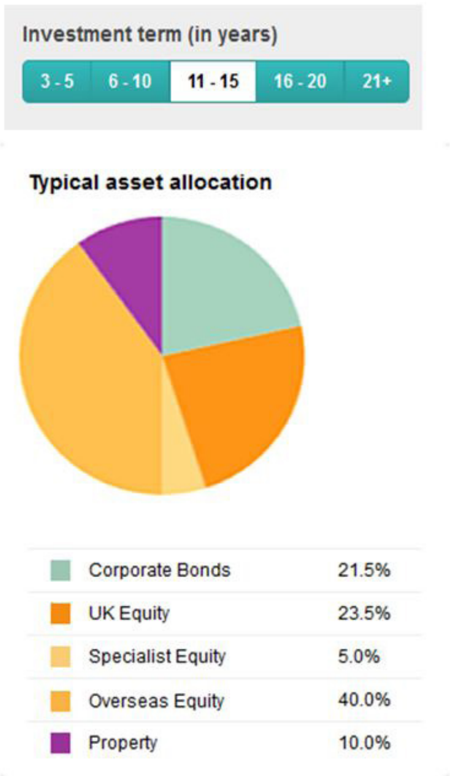
Over 15 years this fund is rated as risk profile 7, using EValue's 1-10 risk profile categories

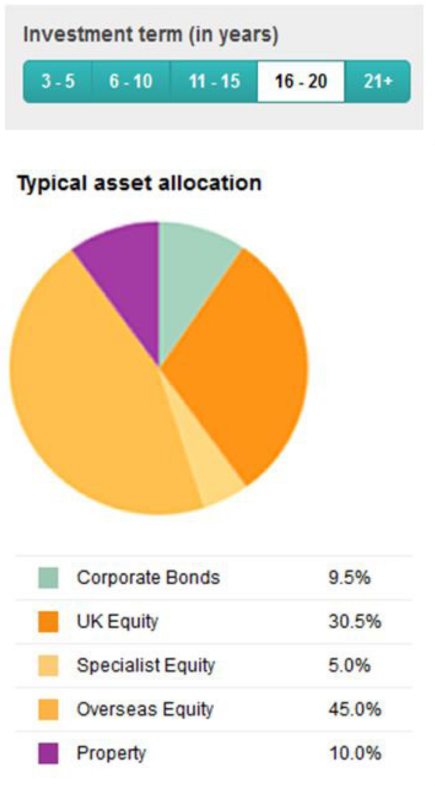


Over 25 years the risk rating for the same fund reduces to 6

The following example demonstrates how a typical asset allocation, for a given risk profile, changes depending on the term of the investment, taking into account the behaviour of asset classes over time.

Over 15 years there is considerable exposure to corporate bonds whereas over 20 years the amount of equity content can be increased





STEP 9: UNDERSTAND THE IMPACT OF DIFFERENT LEVELS OF RISK

It is generally recognised that, in order to achieve greater long term investment results, it is necessary to select a higher risk fund or portfolio. Over time in a rising market, more speculative assets will out-perform more cautious ones. It is important however that the client understands that the opposite can apply - in a falling market the more speculative assets will fall more quickly and potentially to a lower level. This emphasises the need to accurately identify a client's risk profile and to regularly review it so that the client's investments remain aligned to his or her risk profile.

In the example below we can see the difference in the potential range of investment terms for different risk profiles, which are forecasted using EValue's asset model.

An illustration of two different risk profiles (4/10 and 8/10) based on an investment of £10,000 over a term of 10 years

Investment risk profile: 0 1 2 3 **4** 5 6 7 8 9 10

Selected risk	Cash comparison
£18,000	£16,100
£12,300	£11,500
£8,520	£10,000
55%	

With a risk profile 4 investment, the range of forecast returns is between £8,520 and £18,000, with a 55% chance of beating cash over the term.

Investment risk profile: 0 1 2 3 4 5 6 7 **8** 9 10

Selected risk	Cash comparison
£27,100	£16,100
£13,600	£11,500
£7,260	£10,000
63%	

A change to risk profile 8 increases the chance of beating cash to 63%. However, the range of forecast returns is much broader, with potential outcomes between £7,260 and £27,100.

THE EVALUE APPROACH

There will always be a range of factors that can impact the performance of a given investment portfolio, but getting the balance between assets consistently right and in line with your client's goals and attitude to risk is a clear priority for advisers and a requirement from the FCA. Ultimately, it ensures that the advice given is of a high standard as advisers provide recommendations that take into account clients' existing assets, by blending existing and new funds together and matching them to the client's risk profile. This ensures that rather than delivering a 'one profit fits all', advisers can offer investment solutions that are individually tailored to each client with minimal effort.

We hope you found this EValue 'How To' Guide helpful. Look out for others appearing on our website at ev.uk where you can also find details about our range of EValue's adviser planning solutions.

If there is subject you'd like to know more about, then we'd love to hear from you. Please email us directly.

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