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Season 2. Building personal wealth

Episode 6.

Choosing the right level of risk for you

Hi there. Jason here. And in this Money Insight we'll explore the best way for you to decide on the right level of investment risk for you to take on each of your financial goals. And to keep this simple we'll assume that you're happy to choose investments with risk levels in a range somewhere between ordinary bank savings and broadly based Stockmarket linked funds. Remembering that bank savings up to the compensation limit will be safe and secure in the short term but are unlikely to beat inflation over the long term. Whereas Stockmarket linked funds could rise or fall in value from day to day and from year to year but offer the prospect of significantly beating inflation in the long term. We'll explore the potential returns on other types of asset, including government and corporate bonds and commercial property, later in this series.

In the previous Insight you learned a six-point checklist for assessing all the features of any investment you could ever need to look at. Whether it's an ISA, a Pension, an investment bond, a buy to let property or anything else. And now we'll focus in on the three factors for choosing the right level of investment risk to take with your money on each of your financial goals. These are your need, tolerance and capacity to take investment risk. And it's worth noting up front that whilst you'll need to consider all three of these factors for each of your goals, it's the third one, your financial capacity for risk, that should carry the most weight in your decision making. So, here's a three-part checklist for getting your risk levels right.

Now, the first factor to consider is your need to take investment risk, and whilst that might sound like an odd factor to consider after all, no one really needs to take risk this is more about understanding the risk you'd need to take, in order to hit your financial goals at the time you want to hit them, and with the funds you have available. So, for example, if you had £5,000 to invest and you needed that money to grow in today's money terms to £10,000 over the next 20 years or so then you'd need to invest it into assets with some risk attached. If you just left it in the bank it would likely still be worth just £5,000 in today's money terms in 20 years from now. Of course, there are limits to the returns you can expect by taking investment risk. So, you can't keep cranking up the risk to achieve ever higher returns just because you need them. And even with investment funds invested fully in the Stockmarket, you should not expect more than about three per cent each year above inflation over the long term, even though it's been higher than that in the past. But within that constraint, if you're investing long-term, it makes sense to consider what risk you might need to take to achieve your goals with the money you can allocate to them. Of course, the flip side of looking at this factor, if you have a lot of wealth accumulated already, is that you might not need to take much risk at all, in order to achieve your goals. And that's certainly a good position to be in as your longer-term goals start getting closer in time.

The second factor to consider when looking for good investment risk choices is something called your investment risk tolerance (or as it's also known, your attitude to risk). And this is about how much risk you can take with your money and still sleep easy at night. You risk tolerance is driven by two factors: your personality and your experience of investing. Which can include your experiences of other people's investing too. And whilst your personality is likely to be relatively stable over time, your experiences can clearly change a lot. So, all things being equal, you might expect someone who's lost a lot of money, or who knows someone who has, to have a lower risk tolerance than someone who's done well, or seen others do well, from investing. We'll give you some pointers on where to go to measure your risk tolerance later in this series. But for now just remember that whilst knowing your risk tolerance is essential to make smart money choices - we all want to sleep well at night after all - it's driven by our personality and our experiences. So, if you only look at your risk tolerance when deciding on your ideal levels of risk, you could end up being either too cautious or too aggressive with your investments than is good for you. And that's why this third factor is so important.

Your capacity for risk is the biggest factor to consider when deciding how much investment risk you might sensibly take with your money. Your capacity for risk simply means your ability to adapt your lifestyle and other spending to cope with either a permanent loss of capital or long-term returns being much lower than anticipated. And there are four different aspects that might lead you to adjust upwards or downwards the risk level that your risk tolerance suggests. So, let's look at those now.

If, for one particular goal, you're investing over very long term (say 20 plus years as you might with your pension), then you might consider increasing your risk level on those monies above what your risk tolerance suggests, if that's not already higher risk. And this is because any short-term market falls will have plenty of time to recover before the date of your goal arrives. On the other hand, for shorter investment terms of less than, say, twenty years, you might want to lower your risk exposure compared to what your risk tolerance suggests if it's not already quite low. And if, for example, you're making a lump sum investment that you'll need to encash fully within, say, ten years, it might not make sense to invest in risky assets at all for this particular goal. So the number of years you have to invest until your goal arrives – matters a lot. If there's a fair chance that you'll need access to your capital before you reach the end of your planned investment term, or if you plan to make regular withdrawals of more than the income produced by your funds, then this might suggest a need to limit the amount of risk you take on this particular goal.

On the other hand, if you're confident that you won't need to call on your funds during your planned investment term you might be able to consider a more adventurous investment approach. You might have a higher capacity for investment risk on one of your financial life goals, if you plan to keep a reasonable proportion of all your investable funds in bank savings or other low-risk assets. Conversely, if you plan on investing a large proportion of your total funds, you might consider lowering your risk compared to what your risk tolerance test might suggest. Are you investing a lump sum or investing regularly?

And finally, if you plan is to phase your money into the markets over a number of years, as you would with a regular investment plan, then this might suggest you have a higher capacity for risk on this investment plan. Whilst investing a large lump sum on a single day might suggest a need for a lower risk approach.

Choosing the right level of risk to take on any investment for any financial goal is a balancing act between the factors we've looked at here: your need to take some risk; your attitude towards risk and; our capacity to take it. And getting this balance right is about being able to sleep easy at night, despite fluctuations of stockmarkets in the short term and about making it easier to achieve your goals in the long term.

In the next Insight we're going to look at the different types of assets you might choose to invest in, and the types of returns you might expect to get from them. See you back here when you're ready for that. All the best.

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