Living with investment risk

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> For the purposes of this article, we look at investment risk as the chance of losing all or some of your savings.
>
> We note that risk is more than simply losing some money, but avoiding the permanent loss of money is important.

With everything we do in life there is an element of risk. It is therefore, important to learn to live with risk and to develop plans to manage the potential consequences. With investments, part of those plans will likely involve having some cash assets, to meet your short-term needs and any unexpected costs that may arise, and also having some shares/property assets to protect against inflation. However, while most portfolios will have some shares/property, they should only do so if it is possible to wait for the markets to recover before there is a need to sell, because share and property markets go up and down.

In living with investment risk, we need to learn to:

1. Understand the return (income and growth) that is needed year-by-year on the capital, and when the capital is required back;
2. Choose types of investments that are appropriate for each of the financial needs individually, as opposed to adopting a single strategy to cover all the needs on average.

Then,

3. Look through the short-term "noise" and market movement, and focus on the longer term outcome;
4. Make sure that there is appropriate diversification. This is particularly important when there is limited or no control and influence over the day-to-day management of the investment;

With investments, one of the risks relates to the potential to lose money. Losing money is not limited to shares and the share market, but to all investments of cash, bonds, property and shares. Yes, if the markets go down, the value of the investment goes down, but unless the investment has to be sold before the market recovers, it is not a permanent loss. The potential to lose money arises if we are not diversified, or have to realise the investment, or we choose to realise it before it recovers. Therefore, to achieve higher returns, we need to learn to live with the volatility and to understand how long we can wait for the market to recover, before the savings need to be spent. Being able to wait for the markets to recover is important.

Cash is not risk free

If money is put under a mattress, there is the obvious risk of theft or fire. But the more important risk, is the risk that the money when taken from under the mattress, will not buy as much in the future as originally was thought. This is the risk that we lose money in real terms through inflation. If this happens we may still have the money, but our true

The legal stuff
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spending power has gone backwards. The longer we leave money under a mattress, the higher the inflation risk and the greater the potential for a loss in real terms.

One alternative is to put the money in a bank. By putting the money in a bank, the risk of loss through theft or fire is reduced and there is also the benefit of the interest received. As the bank deposit interest rates are normally above the expected inflation rate, we also reduce the risk of the loss of purchasing power (i.e. a loss in real terms). However, it must be remembered that banks are not absolutely safe. The risk of a permanent loss of the savings is not prevented, as the bank is not guaranteed - if the bank gets into difficulties, there is a possibility that part of the savings will be lost. The 2013 experience in Cyprus was a good illustration of this.

The security of a bank depends on the nature of the activities the bank and in the bank's risk management policies. Banks take an investor's money and invest it elsewhere; normally by lending it to individuals, businesses, property developers, etc, to get a higher return for the bank's shareholders. If the activity that they lend the money to turns bad, the bank may not get its money back and in turn, if it happens too many of its investments at the same time, the bank may not be able to pay the depositor's money back in full.

This risk of capital loss from a bank can be reduced by investing the cash across many banks (diversification) and by understanding the business practices of the banks and the strength of their balance sheets (i.e. the likelihood that the bank may go under), but the risk cannot be eliminated.

An alternative is to by-pass the bank and invest in the business activity direct

In some cases, it may be better to invest in a business direct and not indirectly through a bank. If money is invested directly in a business, the return is the share of the profits of that business and ultimately the ability to sell the shareholding for more than was paid. This is also not risk free as many businesses fail and the profits from one year to the next, can vary a lot. With share investments, the key is to understand the potential profits of the business and the potential to sell the share (i.e. its marketability). If the profits reduce, the return of the share is likely to reduce. The profits of a business may reduce for many reasons. In some cases, they are business specific (e.g. poor management) and in other cases, it is due to adverse wider economic conditions, either locally or globally. Where the management is sound and it is a quality business, down-turns due to general market conditions normally self-correct with time. This risk can be managed by ensuring that there is not a need to sell the business to realise money, to spend at a particular time. Being able to wait for the recovery is important.

As many businesses fail, by investing in a single business, there is a higher chance of a loss, unless appropriate due diligence is undertaken and there is some influence, or control over the management and direction of the business. The chance of failure can be reduced by investing in many businesses (diversification), but this also reduces the expected net return because of the higher costs of doing so. It is therefore important to

get the right balance between diversification (risk reduction) and incurring additional costs.

Often, businesses are bought through a mechanism like a share market and possibly a managed fund. Both of these are often more convenient but introduce a further risk, as they introduce a layer between the investor and the business and introduces further costs. The additional layer introduces an unknown and therefore uncertainty, and reduces the investor's influence and control over management. Again, a good way of managing this risk, is diversification. By buying more shares through the market, the chance of capturing the general return available in the market is higher and the impact that a bad investment will have on the total return is reduced.

A diversified share portfolio normally protects investors from a total and permanent loss, but they are still exposed to a partial loss unless they can wait for the market to recover before they sell. Short-term, it is nearly impossible to avoid a market down-turn. In most cases, it is better to learn to live with the risk, then to look to avoid the risk by not buying shares.