Investment risk
Balancing investment risk and potential reward
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When constructing your investment portfolio, you need to consider the risks as well as the potential rewards.

This guide helps you understand investment risk and how it can potentially affect your investments.

The key areas it covers include:

1. Understanding risk.
2. Your risk-return profile.
3. The historical risk-return trade off.
5. Different kinds of risk and how they are measured.

From reading this guide you will have a greater understanding of the risks associated with different types of investments and be able to discuss them with your financial adviser.
3 Understanding investment risk
4 Understanding your risk profile
6 The historical risk-return trade off
8 The importance of setting objectives
10 How professionals manage risk
12 General risks
14 Understanding asset-related risk
16 What next?
Understanding investment risk

All investments carry some risk, but the level of risk varies depending on which investments you choose. In general terms, the higher the risk, the higher the potential return – and the higher the potential loss. You simply can’t build an investment portfolio without considering a number of aspects of investment risk.

More risk for potentially greater reward

Generally speaking, you may need to consider accepting more risk if you want to pursue higher returns. If you decide to seek those potentially higher returns, you face the possibility of greater losses, including some or even all of your investment.

The effect of time on risk

The longer you invest the more time that riskier investments, such as equities, have to recover from any falls. Bear in mind, however, that long-term investing does not guarantee that you will meet your investment objectives.
Understanding your risk profile

Your personal risk profile shows how ready you are to potentially lose money in return for the prospect of rewards. Your profile depends on your attitude to risk and your reason for investing. It also depends on your financial situation and how long you have to invest.

Your attitude to risk

If you have a high risk tolerance you may be more willing to have riskier and more aggressive investments in your portfolio, such as equities or property, in the hope of making potentially higher investment returns. If you are more cautious, you may want to focus on preserving your original capital as much as possible and prefer more stable, low-risk investments, such as bonds or cash, even though these are likely to offer more modest investment returns.

Your risk profile over time

Your risk tolerance will change over time. At the most basic level, there may be a time to take risks to grow your money; a time to preserve wealth and a time to live off that wealth. Investors in their 20s may not be too worried about a big drop in markets, reasoning they have time to ride it out and profit in a later recovery. Investors in their 50s on the other hand, may focus more on protecting against loss of wealth.
Your adviser can help

Each investor will have a unique risk profile, which is why you might wish to speak to a financial adviser. They can help you determine your risk profile and work with you to develop an investment plan that’s right for you.

**Equities**
Equities, sometimes called stocks or shares, represent ownership in a company. These offer the potential for higher returns, although with higher risk.

**Bonds (fixed interest)**
A bond is a loan made to the bond’s issuer. This could be a company (known as corporate bonds), a government (UK government bonds are also known as gilts), or some other institution. Different types of bonds vary greatly in their risk profile, although government bonds are considered one of the least risky investments.

**Property**
This can include your own house, as well as pooled funds investing in commercial property offered by an investment management company.

**Pooled funds**
Pooled funds are professionally managed investment funds which invest in a range of assets.

**Cash**
Usually includes cash held in bank or building society accounts or pooled funds that invest in short-term cash instruments such as those issued by the UK government.
The historical risk-return trade off

All investments carry some risk, but historically, different investments have demonstrated different risk and return characteristics. In general terms, the higher the risk the higher the potential return and vice versa.

Risk and return over time

Different types of investments, sometimes called assets classes, tend to have different risk/return characteristics over time. The chart on the opposite page shows the historical performance of different investments over 20 years. Each type performs differently each year and it’s very difficult to predict which will perform well at any given time. For example, equities have outperformed other asset classes in most years, but have also produced the largest and most frequent negative annual returns.

Based on this historic performance, investment professionals tend to rate the different types of investments according to a risk/return hierarchy, which reflects that if you want greater rewards, you may need to accept greater risk.

The risk/return hierarchy

This diagram is illustrative only and reflects the general way that risk/reward for the different asset classes is viewed. However, past performance is not a reliable guide of future returns and there are varying degrees of risk within each asset class.
The performance of different investments from 1994–2014

The performance of an index is not the exact representation of any particular investment. As you cannot invest directly into an index, the performance shown in this table does not include the costs of investing in the relevant index. Basis of performance nav to nav with gross income reinvested. Indices used: Equities (MSCI AC WORLD in GBP, Source: Thomson Reuters Datastream), Bonds (Barcap Gl. Agg, hedged in GBP, Source: Barclays), Cash (3M LIBOR, in GBP, Source: Bloomberg), Property (FTSE NAREIT Developed Index, in GBP, Source: Thomson Reuters Datastream).

Past performance is not a reliable indicator of future returns.
Different time frame, different approach

If you are investing for the long term, say for retirement for example, you might choose to hold some equity based assets. On the other hand, if you have to pay for a short term goal such as a wedding, you may decide to hold more cash. Deciding on the basic structure of your investment portfolio is called asset allocation.

Different objectives, different portfolios

Younger investors or those with a higher tolerance for risk might seek a more aggressive investment strategy that holds a higher proportion of equities since they may deliver greater returns over the long term, but at a higher level of risk. Older investors or those with a lower risk tolerance, who are seeking to preserve capital might want to hold a greater proportion of cash and bonds, which also have the advantage of paying a certain level of income.

The examples on the opposite page illustrate how this might work. Whatever your risk profile, time frame and investment objective your financial adviser can work with you to determine the appropriate types of investments with the right level of risk and potential reward.
Hypothetical model portfolios

The conservative portfolio has a low proportion of equities, and may suit those with low risk tolerance and/or a short time to invest.

The moderate portfolio has a lower percentage of equities compared to bonds, and may suit investors with medium risk tolerance and/or a medium investment time frame.

The adventurous portfolio, with a high proportion of equity-based investments, may suit investors with high risk tolerance, and/or those with a long investment time frame.

These examples are hypothetical portfolios, and are provided for illustration purposes only. They are not a replacement for financial advice.
You can learn a lot by studying some of the risk management strategies used by professional investors. Four of the most prominent include diversifying across asset classes, using pooled investment funds, pound cost averaging and adjusting portfolios (sometimes called ‘rebalancing’).

**Diversification**

Diversification means spreading your investments across different asset classes and sectors. By not having all your eggs in one basket and by holding investments that tend not to rise and fall together, you can manage the overall risk of your portfolio.

**Pooled investment funds**

Professionally managed investment funds invest in a range of assets, giving you automatic diversification within a single fund. These funds come in a multitude of types from many different investment management companies. Your financial adviser can help you decide which ones may be appropriate for you.
Pound cost averaging

This refers to building up an investment through regular contributions, rather than investing one lump sum. So, when prices are high, your contribution will buy fewer shares or units – but when prices are low it will buy more. This way, you reduce the risk that you pay too much when the price is unusually high and benefit from buying more shares when the price has fallen.

Adjusting your portfolio

Market fluctuations can affect your mix of assets and change the risk/return profile of your portfolio. Sometimes referred to as ‘rebalancing’, adjusting your portfolio back in line with your investment objective helps to ensure that your portfolio does not become overly invested in a particular type of investment, and thus change its risk profile so that it’s out of line with yours.

These techniques are provided for educational purposes only. Your financial adviser can give you more information about these concepts and how to use them in practice.
Inflation risk

Inflation is like a stealth tax eating away at the value of money. You won’t see a smaller cash balance in your account, but you will definitely lose buying power. In other words, the amount that you can purchase with each pound in your pocket slowly erodes over time.

Many savings accounts fail to pay a return that beats inflation, especially after tax is deducted. So even if you reinvest every penny of your interest, the real value of your savings could fall.
Shortfall risk

This means the risk of failing to meet your long-term investment target. This could mean that you didn’t take on enough risk to get the potentially higher rewards, or that you took on too much risk and your portfolio fell in value.

Economic and political risk

Economic and political factors play an important role in the performance of investment markets. Economic factors include economic growth, inflation, employment, interest rates and business sentiment. While political risk includes changes in government, political uncertainty and international conflicts.

For example, if you are saving for your retirement, putting all your money into a savings account may not build enough capital to produce the income you will need in retirement. On the other hand, you could also be exposed to shortfall risk if you invest in too many high risk assets causing your portfolio to lose value at the wrong time.

So investing too aggressively or too conservatively can each lead to shortfall risk.
Understanding asset-related risk

Each type of asset has its own associated risks. Your financial adviser can give you more information on how to manage these risks in your portfolio.

**Country risk**
The risk that domestic events – such as political upheaval, financial troubles, or natural disasters – will weaken a country’s financial markets.

**Credit (or default) risk**
The possibility that a bond issuer will fail to repay interest and capital on time. Funds that invest in bonds are exposed to credit risk.

**Currency risk**
The risk that changes in currency exchange rates cause the value of an investment to decline.

**Interest rate risk**
The possibility that the prices of bonds will fall if interest rates rise.

**Liquidity risk**
The chance that an investment will be difficult to buy or sell.

**Manager risk**
The chance that a pooled fund will underperform due to poor investment decisions.

**Market risk**
The risk that any market such as equities, bonds, property, or cash, may decline.
Volatility risk
As we saw earlier, different types of investments fluctuate in value over time. This is referred to as volatility and is often used to assess the potential risk associated with an investment.

Sector risk
The risk that a particular sector within a market, such as the oil and gas sector, or the travel sector, may decline in value. For example, if oil prices surge, the oil and gas sector might rise, but the travel sector might fall due to rising fuel costs.

Specific risk
The risk that a specific share, bond or fund you’ve invested in performs badly.
This guide has shown that understanding risk is a key part of developing your investment portfolio.

With your knowledge of risk, you will be able to work with your financial adviser to create an investment portfolio that suits your risk profile and meets your objectives.
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