Ethical Investors

Understanding Investment Risk

Introduction

This guide has been written to assist our clients to broaden their understanding of investment risk and, importantly, to put the issue of risk tolerance into the context of investing their money. This paper should be read in conjunction with our separate “Risk and Reward” paper available on request.

The advice process at Ethical Investors has evolved over the 25+ years that we have been in business, and it invariably follows a similar pattern with all clients. The initial phase involves the completion of a client information form or fact find; with Ethical Investors this form includes all of the standard questions about personal and financial status, objectives and requirements from the financial advice process. The additional element for the ethically motivated investor relates to their ethical views and the framework within which they wish to have their investments, savings and pensions to be held. One of the most important areas that needs to be considered is investment risk, and this can present a number of challenges, because fundamentally all investors wish to have minimum risk married to maximum return, and that is obviously a difficult feat to achieve.

The purpose going through a risk analysis is to assess your attitude to risk, your tolerance for risk and the potential for loss. We are looking at investment risk here; how much of your money are you going to move away from the apparent security of a bank/building society savings account and invest elsewhere.

There are a number of background issues that are important to address before dealing with the main risk area. Firstly, while many savers believe that cash savings (bank and building society accounts) are risk free, that is a common misconception; banks and building societies can fail, so the compensation risk is very real (we have luckily managed to avoid such a failure in the UK to date). Furthermore, while the quoted rate of interest will not fluctuate in the same manner as a stock market investment, the risk to the value of capital within savings accounts is very real, and is demonstrated very clearly in the graph shown later.

At Ethical Investors we divide investments into two very simplistic categories; savings and investments. Savings comprise money held in bank and building society accounts; places where quoted rates of interest are paid, but where there are none of the fluctuations in value that arise as a consequence investing in the stock market. Investments comprise anything where there will be variations in value based upon a myriad of factors from stock market price movements to currency variation and political change. Pension funds, Stocks and Shares ISAs and all other similar investments exposed to stock markets and equities fall into this category (if you are beginning to lose heart in reading this document due to the increasing use of investment terminology, please see our separate Glossary of Terms which, we hope, provides a digestible explanation of industry speak).

We are often asked in relation to invested money in pensions, stocks and shares ISAs and general investments "what if I lose all of my money"? While it is not impossible nor inconceivable for this to happen, it is worth being aware of the sequence of events that would need to transpire for a total loss to arise; most investment funds that underpin investments hold an average of 80 different investments in companies that are listed on a stock market. For total loss to occur every one of those companies would need to fail, which while not impossible, is exceedingly unlikely, and would be a likely precursor to a massive implosion in the financial world.

When we start to construct a portfolio of savings and investments for all clients the first step is to decide how much should be held in savings and how much placed into investments. It is important to realise that money can be moved from one category to another and back again, so the division between these areas is not fixed and inflexible. Furthermore, we often adopt a gradual approach to moving money from savings to investments to avoid the potential for a sudden fall in investment values right after the money is invested.

The decision as to how much should be held in savings is very personal and needs to consider a number of factors. Allocating a certain percentage of money to savings and investments is a reasonable starting point, but is a bit too simplistic to be used for all clients in all circumstances.

For example, an investor with £10,000 to invest might only want to hold 10% in investments, leaving the rest in their savings account. To have £9000 in a savings account as their only emergency reserve would be sensible as the £9000 won't last long if an emergency arises.

However, someone with £1M to invest might be considered more than a little cautious to only invest 10% of their money and hold back £900,000 as their 'emergency' fund. Of course it does all depend on personal circumstances but £900,000 would cover a very large number of unforeseen emergencies!
Other factors that will influence your attitude to risk will be your employment status, job security or if retired whether your living costs are met comfortably from your pension. In all these circumstances individuals are going to hold more or less money in their cash reserves to meet their personal circumstances.

A self-employed person would want to hold more in their cash reserve when their income fluctuates wildly but someone who feels they are in a secure job would probably hold less as their emergency reserve. A retiree with a fully inflation protected pension income might want to invest more for growth for the benefit of future generations compared to someone whose modest pension income isn't enough to live on and who needs the peace of mind of knowing that their savings are easily accessible and not fluctuating in value every day. Rather perversely, the latter retiree is the one who logically should be investing more to boost their capital over the long term to improve their income prospects but emotionally this will be a hard thing to do. We did say that logic plays second fiddle to emotions.

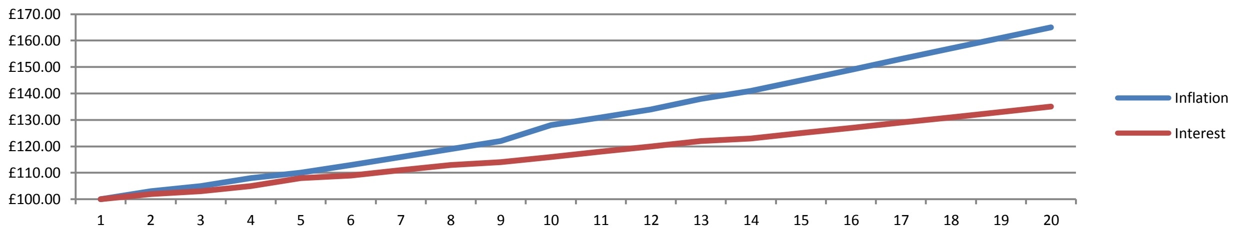
At Ethical Investors we acknowledge and accept that your emotional response to risk must be allowed for, which is why we do not herd clients into standard risk blocks and we do not treat everyone the same. Your attitude to risk can only be partly based on a logical interpretation of the issues in this document. The majority of the process in arriving at your overall attitude to risk will be based on pure emotion and doesn't have to be rational or make sense to anyone other than you. It's OK – we get it.

What is investment risk and isn't money in the Building Society the safest place?

The simple fact is that there are few, if any, options to have no risk at all. Everything you do with your money is subject to some form of risk. Even options which appear to be safe (Bank and Building Society deposits and even Government Gilts) carry an element of risk; sometimes substantial long term risk. In some ways risk, like beauty, is in the eye of the beholder. Each individual will have a different risk tolerance and will take a different view on where and how they wish their risk tolerance to be applied.

The impact of inflation – some sobering facts

Watching the value of your savings accounts increase each year when interest is added gives one a warm glow. Once the effects of inflation are taken into account though, the glow fades quite quickly. The graph below shows what happens to £100 over a 20 year period, assuming inflation is running at 2.5% and the amount of net interest earned on a savings account is 1.5%.



In the early years there isn't a great deal of different between the interest being added to the savings account and the overall effect of inflation. However, beyond year 5 the position begins to worsen quickly so that by the 20th year the gap is huge – and financially very costly. As you can see, after 20 years your original £100 needs to be £165 just to buy the same things that £100 would have bought you when you opened your savings account. However, the amount of money in the savings account is only £135, so you've lost £30 in real terms.

How does Ethical Investors apply Risk Profiling to the advice process?

In simple terms, we apply a two stage process; what is your personal 'capacity for loss' with your total (non-property) assets and, secondly, what level of risk do you want to apply to the money you decide to invest outside of your cash reserves?

We seek to understand what level of risk you are comfortable with at Stage 1, and then we wish to establish what level of risk you wish to apply to the money you invest long term, in Stage 2.

Stage 1: **Capacity for loss** – here we are asking you to think about your attitude towards potential investment loss, balanced with the need to protect your money against the long term effects of inflation. For example, investing all of your capital in the stock market is a full on growth strategy but leaves nothing as an emergency reserve and would be considered a very high risk strategy. In the long term the strategy might pay off but on the way it is going to be a real roller coaster ride!

The other extreme is to hold 100% of your capital in a bank or Building Society account; this feels lovely and safe but if you are earning 1.5% interest and inflation is running at 2.5%, then in reality you are losing 1% of your capital every year.

So, assuming neither of the two extremes is chosen, there needs to be a level of compromise in between. You need to decide how much of your money you are going to take away from the short term security of cash holdings (Banks/Building Societies/National Savings etc) and invest in longer term areas where the value of your money may be moving up and down on a daily basis but the overall return over the medium to long term is expected to beat inflation.

Stage 2: **Investment allocation risk** – once you have decided how much money you wish to move away from cash holdings, we need to understand the level of risk/return that you want to apply to this money. For example, a client might choose to hold 90% of their money in the building society and invest 10% on the stock market in ethical funds for the longer term. The reason for investing 10% in ethical funds would be to generate the highest possible return from the non-cash money and in this instance the client might want to apply a risk rating of 4 to the underlying investments. What this says in practice is …...*I want to know that 90% of my money is not going to go down in bad times, even though I know it won't keep pace with inflation over the long term. To try to get back some of the money lost to inflation, I want to make as much as possible from the 10% invested in ethical funds and therefore I will accept the ups and downs to generate the highest possible return.*

But what does this mean, in reality, from an investment perspective? Is a 90/10 split really safe? Well, it depends upon how each individual sees the concept of risk and, critically, how they feel about the long term effects of inflation. The table below shows what sort of return is needed from a stock market based investment to produce a return of 2% above inflation on one's entire assets (cash holdings and longer term investments). For each of the 6 scenarios we have used a different capacity for loss rating to see how much stock market funds have to grow by each year to meet the total target return.

Assumptions:

Inflation: 2.5% pa	Interest earned on savings: 1.5% (net)	Desired Total Return on entire assets, above inflation: 2%*

* this is the level of real growth in one's money each year above inflation. So, with inflation running at 2.5% and a real return target of 2%, the total return on one's money needs to be 4.5% per annum. For obvious reasons, if a target return of 4.5% is needed and 100% of one's money is tucked away in a Building Society earning 1.5%, the target will never be achieved and over the long term the real buying power of one's money will devalue; you'll just get worse off every year even though it doesn't look as though the amount of money you have is going down. Of course, the amount of money you have is going up when interest is added, but what you can actually buy with that money is going up at a faster rate and therefore your 'spending power' is falling.

% held in Cash Savings	**% Invested in the Stock Market**	**% return needed from the Stock Market**
90%	10%	**31.5%** per annum
75%	25%	**13.5%** per annum
60%	40%	**9%** per annum
50%	50%	**7.5%** per annum
40%	60%	**6.6%** per annum
25%	75%	**5.5%** per annum

As you can see, there are conflicting levels of risk in the above figures; the person choosing to hold 90% of their money in cash savings needs to invest in **extremely** high risk assets to try to generate the same 'total real return' as someone with who holds 50% of their money in cash. It seems counter intuitive but it is a fact; the more money held in longer term investments the lower the overall investment risk needs to be and the more cautious a person is by holding most of their money in cash the more they have to hold riskier investments elsewhere. Strange but true!

Positive Investment

Ethical funds generally operate on a ‘negative screening’ approach. This means that companies involved in certain defined areas will be avoided. The fund managers are then free to invest in any other companies that they feel will provide the long term income/growth for the fund.

The vast majority of investments within an ethical fund would normally be classed as ‘ethically neutral’; the companies are not doing anything that would breach the ethical criteria but they are not necessarily involved in ‘positive’ areas such as clean energy, recycling, clean water, social benefit, waste management, combating climate change etc.

There are funds which are invested positively, some of which may invest in a single area such as Solar Power. Because these funds are highly targeted with little or no diversification across different sectors, they are deemed to be much higher risk than the more mainstream ethical funds. The rewards may well be significantly higher too. Because the positively invested funds are a completely separate investment type, we offer clients the opportunity to indicate how much of their money they would like to invest in these funds; effectively you have the opportunity to allocate some of your money to a basket of managed ethical funds and a separate amount to positive funds. Our Investment Review Committee will meet each quarter to assess which of the mainstream ethical funds are delivering the strongest returns and make sure that our clients holding these - by recommending to each client that Fund A is sold in favour of better performing Fund B. Most such switches are carried out free of charge.

Because the Positively targeted funds are very much seen as a long term hold, it is less appropriate to keep switching in and out of these funds. If we removed any emotional response to the idea of investing positively and looked at it from a cold hard investment risk perspective, no one should be investing in positively invested funds whose investment risk is less than 4.

To ensure that the advice we offer remains compliant whilst at the same time allowing room for emotional investment decisions, we offer clients the opportunity to separate positive investment from their main investment risk profile. The simplest way of doing this is for you to select a specific amount of money that you wish to place into positively invested funds. This money will not be subject to your main risk rating and will not be part of the overall managed service we offer for your main investment funds.

For example, you might decide that you have an overall investment risk profile of 2 which would automatically disqualify us from recommending any of the positively invested funds. That said, you could direct us to invest £5000 in positively invested funds with everything else invested according to our risk level 2 allocations. We would make two recommendations; the first would be how your main investment money should be invested in accordance with your risk profile and the second would be to recommend a fund or funds which are positively invested.

Rebalancing

Once you have selected the level of investment risk you want to apply to your money, our advisers will recommend the most appropriate funds within each of the asset classes. Over time the different asset classes (Corporate Bonds/UK Funds/International Funds/Property etc) will produce different returns, creating the position that the overall allocation might push you into a higher or lower risk level. If this happens over a long period of time, your investments will not reflect your selected attitude to risk.

Rebalancing is an automatic process where, at least annually, your investments are ‘rebalanced’ back to your original risk profile. In most cases you will continue to hold the same individuals funds, but the allocation between Corporate Bonds/UK Funds/Property/International Funds will be brought back to be within the ranges set when you selected your original risk profile. Ethical Investors’ clients will have their main investment in ethical funds rebalanced annually (this excludes the separate allocation to Positive investment funds which are seen as a long term hold).

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Ethical Investors

Specialists in ethical financial management and clear, transparent advice