AWFM Fact File

“Understanding Risk”

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AW Financial Management LLP

Financial Planning
Independent Financial Advice
Investment & Wealth Management

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Whether you keep money in the Bank, under the bed or in some form of investment, the one constant is risk, although the degree depends on what exactly you do with it. Our job is to help you achieve the best possible outcome for an acceptable level of risk.

It is important for us to assess the level of risk that we believe you can afford to take with your assets. If you take too little risk, the value of your funds may not keep pace with inflation or in the case of pension drawdown, for example, the withdrawals you take. If you take too much risk, you may feel a great deal of unease if markets are very volatile. It is therefore important for us to establish the level of risk that you are comfortable and financially able to take. This is commonly referred to as your Risk Profile and your Capacity for Loss.

AWFM Approach to Assessing Risk
Our approach to assessing risk for most clients is measured on a scale of 1-5 where ‘1’ is deemed to be low and ‘5’ high risk. Your investment time horizon is also important context for the risk profile – the shorter the investment term, generally, the more cautiously invested the funds will need to be as there will be less time to recover in the event of falling asset values. By the same token, a longer time horizon affords more opportunity to withstand short- and medium-term fluctuations in the hope of stronger long-term returns.

Using pension funds as an example, if you wished these to purchase an annuity within say three years of making your investment, and the resultant income was integral to your retirement planning, we would advocate a very low level of risk to suit this short investment term. Otherwise, were the value of the pension fund to fall significantly ahead of purchasing the annuity, the resultant guaranteed pension income it could buy would be locked in at a lower level for the rest of your life. Your *capacity for loss* with these funds would, therefore, be very low in this scenario.

Conversely, if you intended flexibly to access your pension in retirement, enabling the pension fund to remain largely or wholly invested - possibly for the remainder of your life - a long investment term is more appropriate. It would be reasonable then to take a *higher* (not necessarily “high”) level of risk in order to target stronger returns. If no risk were taken, there would be little or no investment returns and withdrawals to fund retirement income would probably result in capital erosion each year. Therefore, if you have no *capacity for loss,* for example because your pension funds are relatively small and you have no other assets to fall back on, then you are arguably not in a position to take on investment risk with your pension.

This is one of the reasons why, from the outset, we gather information about your assets, financial goals and overall circumstances which together help us assess your capacity for loss and investment time horizon. This detail and discussion around the prospective underlying assets, their past performance (although not relied on as a guide to the future) and of industry standard benchmarks help us gauge your attitude to investment risk. We will then construct, in outline, an appropriate risk profile to meet your needs which, in turn, will help us formulate our initial advice regarding the investment of new or existing financial assets. If you then engage us under our Wealth Management Service to issue and implement specific recommendations, we will look to supplement our initial risk discussion with completion of an Attitude to Risk Questionnaire (‘ATRQ’).

The Main Investment Asset Classes
Regardless of the structure or wrapper containing it, an investment will typically fall in to one (or a combination) of the five principal asset classes. A brief description of each is provided below to assist in understanding our investment recommendations:

Cash/Money Market

This is usually the most secure type of investment where returns are likely to be broadly in line with prevailing Interest Rates. Cash may be held in your own name in a Deposit Account with a Bank or Building Society, in a cash account within a Discretionary Managed Portfolio or invested in a Money Market or Cash collective fund.

A Money Market fund will typically expose an investor to marginally higher risk than funds in one's own name because of the use of 'near cash' instruments and also to an ongoing fund management charge, which combined with prevailing low interest rates may even result in a small loss each year. Money Market funds also carry a unitised price which, in theory, makes their value prone to fluctuation unlike bank accounts which also benefit from statutory capital protection up to £85,000 per depositor per institution. Beyond this level, the creditworthiness of the deposit taking institution (or 'counterparty') may be a factor but, generally, this asset class poses the least risk to the nominal value of your capital in nominal terms although in real terms over the longer term funds held in this sector could start to lose value against inflation.

Fixed Interest / Bonds

Fixed interest securities mainly comprise corporate bonds and gilts which are essentially trade-able loans. Gilts are issued by the UK Government and bonds by corporations - in both cases to raise funds from investors as an alternative to bank borrowing. The investor (or 'creditor') usually receives a *fixed level of interest* (or 'coupon') until the capital is repaid, much like a normal loan. There are other forms of bond such as floating rate notes which pay interest that rises and falls with the prevailing interest rates and, index-linked gilts where the interest varies with changes in inflation.

The coupon is determined predominantly by the creditworthiness – or risk - of the bond issuer. For example, gilts typically offer a lower level of interest as the return of the capital and ongoing interest payment obligations are very likely to be met. At the other end of the scale, high yield bonds are issued by companies with a low credit rating. As in most forms of investment – with higher returns typically comes higher risk and as these issuers are considered less certain to meet their obligations, they offer a significantly higher coupon.

All of these "loans" or bonds are traded by investors, often daily, and so their capital values can fluctuate according to demand which in turn will be affected by external factors such as interest and / or inflation rate changes and expectations. If investing solely for income, bonds and gilts will be an important part of a diversified portfolio. Fixed Interest assets typically provide a greater degree of inflation protection than Cash or Money Market assets due to the higher yields (income) available. However, the price of a bond issued by the most creditworthy of institutions is prone to fluctuation and would be described as a low to medium risk investment.

Alternatives

This asset class covers a wide variety of investments regarded as 'alternative' to the traditional asset classes outlined - from hedge funds to classic cars and even wine. Absolute return funds, for example, which seek to produce a positive return in every environment, or hedge funds which may target returns negatively correlated with the traditional asset classes and commodity funds investing in assets such as gold. Some alternatives rely on derivative contracts such as call or put options, warrants and futures to gain – and in some cases leverage - exposure to either the upside or downside of the underlying asset.

Alternative investments may include a wide range of risks which are beyond the scope of this document. One is that the fund manager makes the wrong calls, and another is the risk of counterparty to the derivative contract not fulfilling its commitment under that contract when it falls due. For this reason, and because of the relatively low level of income produced, we rarely recommend alternatives as a standalone asset in our model portfolios although managed funds or Discretionary Fund Managers which form part of our solutions may include a weighting for diversification or risk management benefits.

Alternative assets are diverse and cover the spectrum of risk from low to high.

Property

For investors with sufficient capital to diversify, property may be invested in directly by purchase of a buy to let property, for example. Alternatively, exposure may be gained as in our model portfolios through a pooled fund with a relatively modest outlay. The benefit of pooled funds is that it is possible to purchase a diversified portfolio of Property investments, including Commercial Property (shopping centres, offices and warehouses) and, in some cases, residential property.

The main attraction of property is the rental income, often linked to inflation in some form, but with the potential for capital appreciation. It is *not* true to say that one 'cannot lose' by investing in property but it enjoys comparatively low volatility (ups and downs in capital value) and does not typically follow the pattern of other investment classes such as equities (see below) and bonds, which helps bring diversification to an investment portfolio. However, some property funds instead invest in the shares (see below) of property companies which may increase day to day volatility but improves liquidity (the ability to buy and sell quickly).

The underlying properties owned by these funds differ from the other main asset classes principally because of illiquidity. Unlike quoted shares, for example, they are not traded and settled on a recognised exchange and instead rely on matching a willing buyer and seller. Although the manager will usually retain a significant cash reserve – partly to satisfy requests from investors to sell units in the fund, as property transactions take significantly longer than with listed shares or bonds. In times of economic stress, therefore, it may be necessary for the manager to impose restrictions on sales to ensure that all investors are treated fairly and this could mean either accepting either a significant write-down in the value and / or delay in receipt of proceeds from your holding in the fund. Furthermore, valuations of the underlying assets are regularly carried out for the managers by property professionals, but these are largely a matter of opinion backed up by historic comparable transactions which may turn out to be unreliable when tested.

Consequently, *restrictions are sometimes placed on withdrawals from property funds, for either economic or fund specific issues.* For this reason, we tend to recommend a weighting to property of no more than 10% or so. As mentioned above, property values can and do fall, potentially significantly as in 2008, and are usually categorised as medium risk.

Equities

Equities, otherwise known as 'shares' are typically traded on the Stock Market. They have historically provided higher returns than cash and bonds over the mid to long-term but tend to be more volatile. The uncertainty over future price movements make them a riskier investment than some other asset classes. A company's share price may be determined by general market factors, such as the state of the economy, but also by its trading performance relative to the market and its peers. If profits are down, this will probably depress the share price although in some cases, for example if anticipated 'bad news' is not as bad as expected, the price may indeed rise. If, however, the company's profits are improving, or it is subject to a takeover bid, this may well push the share price up although again if the market had higher expectations the price might fall. One of the principal attractions of equities is therefore the ability to buy into improving profitability or growth in a company and more generally the domestic or global economy. This can offer a degree of protection against the effects of inflation, which is often more of a risk when economies are growing quickly. For this reason, equities are likely to be the largest component of *most* investment portfolios.

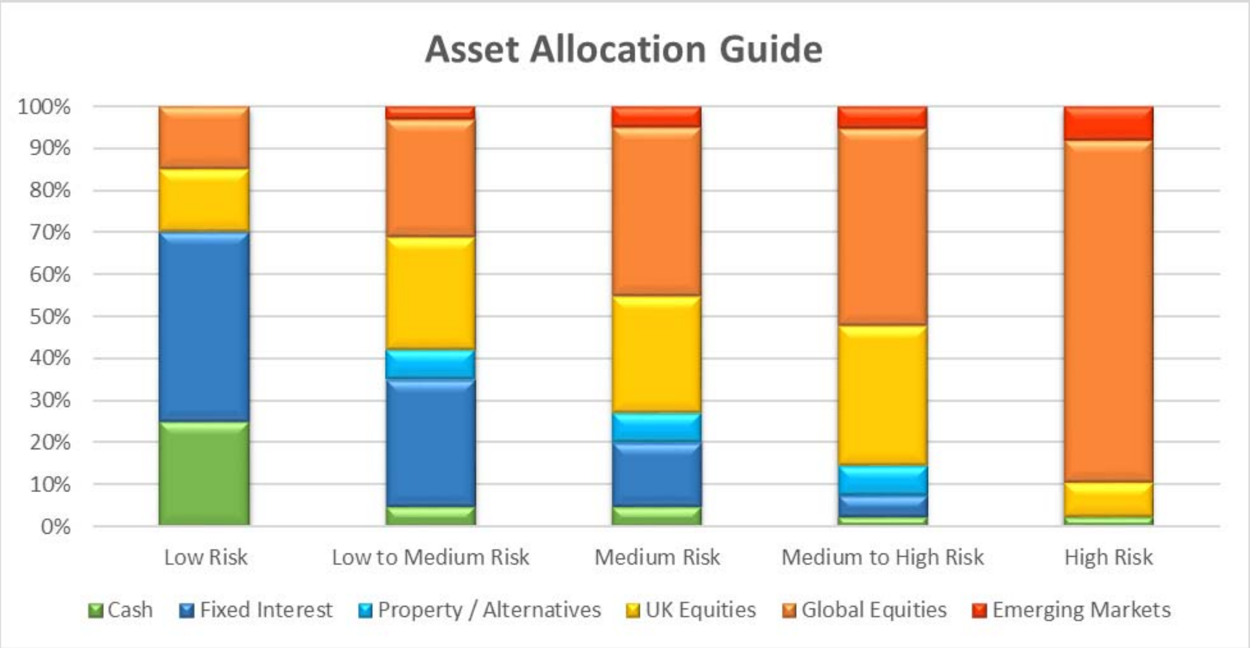
As well as movement in the share price, shares can produce Dividends which are a distribution of the profits of the company. This is an important part of the reason for investing in Equities and typically provide a high and steady income stream or yield.

Equities are typically described as medium to high risk because the value of the shares can go down as well as up, sometimes quite sharply. Shares in smaller companies and in companies within less stable economies (known as Emerging or Frontier Markets) would be classed as one of the highest risk investment classes. Liquidity can also be a risk in relatively small companies, such as those traded on the Alternative Investment Market (AIM) for example. At times, it may not be possible to sell shares held in very small companies, as no willing buyer can be found. This risk is mitigated to a certain extent by investing in a pooled fund, as described above. However, even with this approach, *investors may find that at times of market stress or if many investors are trying to sell their investments, a Smaller Companies Fund may stop investors making withdrawals or adding further contributions to the fund.*

Benchmark Asset Allocations

One – some say, *the* - key driver of investment risk and return is the asset allocation. For example, a portfolio that holds a larger proportion in equities will typically be more volatile and carry more potential for capital loss as well as the potential for superior long-term returns. Conversely, a portfolio with more in bonds will be less volatile and offer the prospect of lower returns over the long term.

The following chart seeks to provide a guide to the typical asset allocations of the five main risk profiles we consider at AWFM. Our portfolios (as well as those run by our DFM partners) will follow a similar asset allocation to these broad guides but with noticeable differences where we or the fund managers selected have decided to make a tactical change in view of the prevailing economic environment or your objectives.



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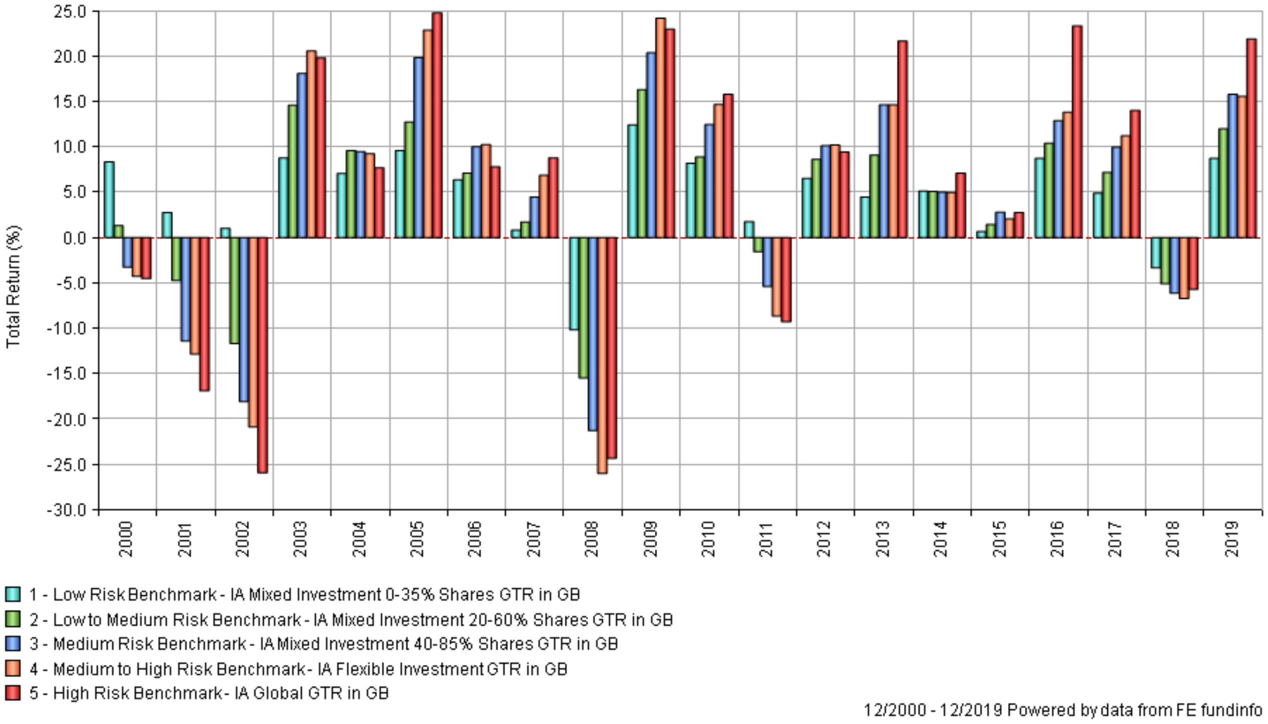
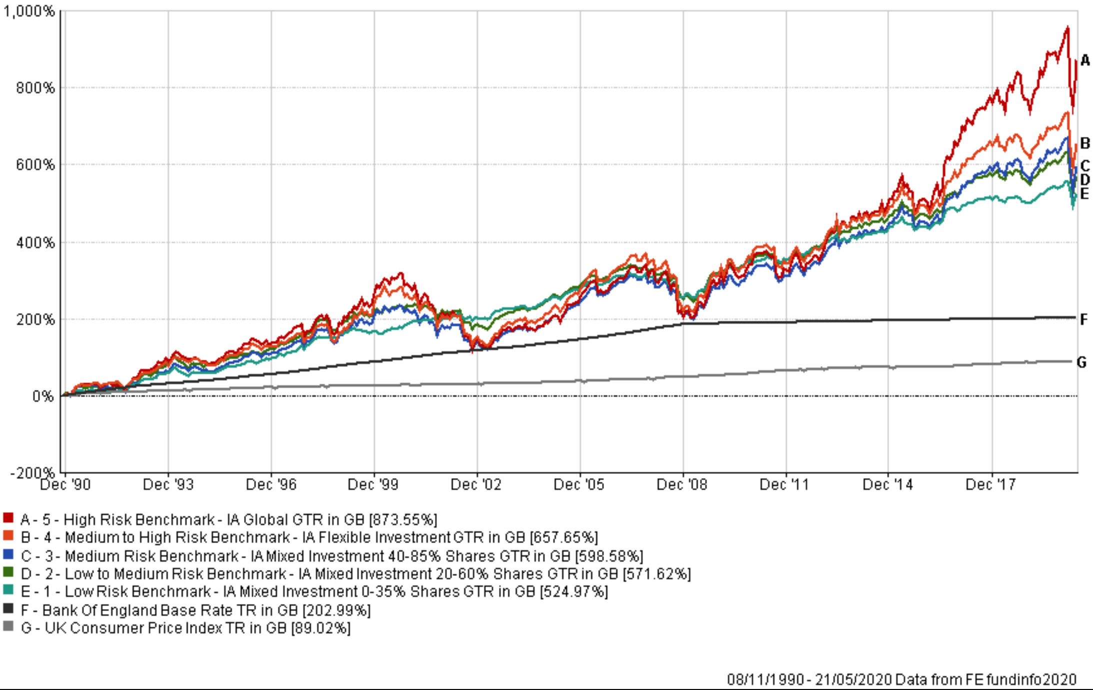
Past Performance Data
The chart below reflects total (capital and income) returns for each of the above risk levels over the last 20 calendar years, using the Investment Association (IA) average of industry wide investment portfolios:



The chart above shows positive returns achieved, to varying degrees, in most years by the majority of risk profiles but also the scope for capital falls as exemplified by the bursting of the "dotcom" bubble (2000-2002), the 9/11 (2001) attack, the US Corporate fraud scandals (2002) and the "Credit Crunch" (2008). You can see that in periods of negative return, the higher risk strategies fell by more than the lower risk strategies. Conversely, when markets were rising, the higher risk strategies produced stronger returns.

This picture is repeated in the following chart which shows cumulative total returns achieved by these risk profiles over a circa 30 year period (as far back as the data allows), including the Bank of England base rate, as a guide to cash based returns, and the Consumer Prices Index (CPI), to show the effects of inflation:



Although, history cannot be relied on as an indication of what lies ahead, these charts demonstrate that in order to improve on returns over the long term, one must be willing and able to accept periods of falling investment values, to a greater or lesser extent. The chart also shows the material change in interest rates and inflation from 2008 onwards, when interest rates were brought to all time lows by the global central banks, meaning that inflation started to outpace returns from cash savings products.

30 Year Risk & Performance Data

The following table looks at key risk metrics for each benchmark, again to give a sense of the *potential* risks and returns associated with each risk level:

30 Year Data	Annual Volatility	Worst Drawdown (Sep 2000 to Mar 2003)	Recovery Period (from low point to previous peak)	Annualised Total Return*	Total Return
Bank of England Base Rate	n/a	0%	n/a	3.76%	202.99%
1 -Low Risk	6.28%	-16.01%	10 Months	6.30%	524.97%
2 - Low to Medium Risk	9.16%	-21.38%	19 Months	6.55%	571.62%
3 - Medium Risk	11.23%	-36.07%	31 Months	6.69%	598.58%
4 - Medium to High Risk	12.24%	-40.95%	33 Months	6.98%	657.65%
5 - High Risk	14.04%	-48.68%	49 Months	7.88%	873.55%

**The Annualised Total Return shown is the Compound Annual Growth Rate (CAGR) which takes into account the effect of compounding returns (i.e. profits are reinvested).*

The effects of inflation (Consumer Prices Index) come to around 2.14% per annum over this period.

- Annual Volatility – The standard deviation of an investment instrument's yearly logarithmic returns! Essentially a measure of risk that indicates the extent to which the investment portfolio returns have varied – up or down - over the period in question. A higher figure indicates a more volatile investment with more rapid and larger movements and a lower number less volatility.

- Worst Drawdown – Shows the greatest possible loss if an investor had made investments at the peak of the cycle for that investment and sold at the bottom. This is principally how losses are crystallised when investing and is something that every investor should avoid where possible. For this reason, investments should be made with a medium- or long-term timeframe in mind.

- Recovery Period – The period of time taken for the benchmarks to recover from their lowest point in a market cycle back to their previous high point.

- Annualised Total Return – The total return per annum of the benchmarks averaged over the last 30 years or so. In reality, returns will vary each year - sometimes to a great extent - but this figure is useful to compare with (risk free) bank deposit returns, for example and other investments.

- Total Return – This assumes the investment income produced is reinvested back into the benchmark portfolio to compound growth. The "Total Return" is therefore a combination of the capital growth and reinvested income.

General Product and Fund Risks

- Past performance is no guarantee of future returns.
- The price of assets and the income derived from them can fall as well as rise.
- The value of most investments cannot be guaranteed and on encashment you may not get back the full amount invested.
- If withdrawals are made at a rate which exceeds the net growth of the fund (after charges), capital will be eroded.

Other Important Investment Risk Factors

- Inflation – when there is a broad rise in the cost of goods and services, the various asset classes will respond in differing ways – some more positively than others. Cash tends to be the most vulnerable to loss of value *in real terms* as it has no scope to appreciate in value - £1 will always be worth £1. Its only form of return is the interest it earns and any compensating rise in rates will usually only occur after a rise in inflation. Fixed interest assets are also sensitive to inflation risk and rises in official interest rates as their income is usually fixed at issuance.

- Currency – For funds investing overseas, exchange rate fluctuations will affect investment valuations in sterling terms. Although the inclusion of non-sterling currencies is another example of diversification, most UK based investors' liabilities are sterling denominated. Holding assets denominated in other currencies or even shares in companies that derive their earnings largely in other currencies will have an adverse effect on performance when sterling is appreciating in value against those other currencies. The opposite is true when sterling falls of course. The main point is that currency movements can benefit or detract from returns and whilst they arguably bring diversification to a portfolio, they also potentially add volatility.

- Global economy risks - Where funds are invested in less economically developed parts of the world, regions with less regulation and / or more limited information, valuations might be susceptible to more extreme price variations. Again, currency (see above) movements may be the largest single factor.

- Ethical funds - have a restrictive investment mandate and as such these funds may not perform as well as funds which do not have such investment constraints.

Summary

The purpose of this Fact-File is to seek to help clients understand investment risk and potential returns by looking at past performance and risk data. *However, past performance is not a guarantee of future performance. Therefore, the potential performance and risk characteristics of these benchmarks, and linked AWFM Model Portfolios/Discretionary Managed Portfolios, cannot accurately be predicted*. The charts and data shown in this document simply set out the risks and returns that have been delivered historically with the various Risk Profiles.

There are other risk matters to consider when investing, such as counterparty risk, liquidity risk etc. More information regarding our approach to handling client investment portfolios (including pensions) can be found in our latest "Our Investment Management Process" Fact-File. As an important document, we encourage you to read through this accompanying Fact-File, along with this document, particularly before committing to any investments.

Information given in this document should not be taken as advice as it is intended for guidance only.
If you wish to have an assessment of your own situation, you should contact the office for advice.