RISK & ASSET ALLOCATION

APRIL 2025

The **level and type of risk** you are prepared to accept is a crucial, perhaps the most crucial part of making any financial plan.

Here we look in depth at **what risk means**, examine the **different types of risk**, and cover **how to assess the level of risk** taken. Once you have decided what levels of risk suit you, you can match your investments to these levels.

This resulting **asset allocation target** will drive your investment portfolio decisions and the returns you experience, so it is important to take time to understand risk and how it feeds into this.

SUMMARY

There are a number of different types of risk – for example, volatility (investment risk), inflation risk, liquidity risk, counterparty risk. Different investments involve different levels of exposure to these risks. The right investment portfolio for you seeks the balance of risks which will suit your individual risk profile and requirements. In all but the most simple cases, it is unlikely that a single product will meet all your needs.

Three different factors need to be considered when assessing your risk rating:

- **Attitude to Risk** – your natural sensitivity to the level of risk taken, such as market falls experienced along your investment journey.
- **Required Return** – how much you need to earn on investments to reach your goals.
- **Capacity for Loss** – how much you can afford to lose should your investments return the worst case scenario over your given timescale for investment.

There may be a mis-match between these factors. For example, you may have a very adventurous attitude towards risk, but your capacity for loss is low, and so you should not take as much investment risk as you may naturally wish to. Discussion with your adviser can help you to realise which factor may need to be changed to achieve your goals.

You may have different risk profiles for different areas of your finances. A basic first step in financial planning is to separate out funds for short term and emergency expenditure. These are usually reserved in cash for easy access, and capital security here will be the highest priority (rather than, for example, reducing inflation risk).

Once you have worked out your desired level of risk, your adviser can then help you set an appropriate asset allocation target for your investments. A suitable asset allocation targets the desired level of return for as little investment risk as possible, and vice versa. Other types of risk such as liquidity and counterparty risk can also be taken into account at this stage.

WHAT IS RISK?

One of the most critical issues for investors is the level of risk they are prepared to take with their investments. In financial terms 'risk' generally means the degree by which the achieved outcome might differ from the expected outcome. When used in financial products, the term risk generally means capital risk and/or volatility. However, there are many different factors which comprise risk, for example:

- **Capital Risk** – the risk that some or all of the capital invested may be lost due to falls in the value of the investment
- **Volatility** – the measure of the degree by which the value of the investment rises or falls in a period, with larger measures of volatility giving rise to larger degrees of risk in the variability of the achieved outcome
- **Inflation Risk** – the risk that the value of the investment is eroded by rises in the cost of living
- **Counterparty Risk** – the risk that the institution that the investment is made with fails to return the value of the investment due to mismanagement or fraud
- **Liquidity Risk** – the risk that the value of the investment is not accessible to the investor when it is required

The degree to which these factors are important will vary widely between individuals, and often one type of risk will need to be balanced against another to achieve a result that is appropriate for the individual's circumstances and comfort levels.

ASSESSING RISK

There are three areas which need examining before an overall assessment of the desired level of risk can be made:

1. ATTITUDE TO RISK

This is a purely psychological measure of an individual's general attitude towards financial risk – not taking into account any personal financial circumstances (although these may, of course, be a factor in an individual's financial risk tolerance). Risk Profilers are generally used as an objective starting point for assessment here. However, as attitude to risk also has a subjective factor, we recommend that discussion with an adviser also takes place to help ascertain an individual's attitude to financial risk.

If the attitude to risk does not match the financial measures below of 'required return' and 'capacity for loss', then further discussion will be required to arrive at a suitable overall risk target for the individual. For example, a client may have a relatively high required return and a large capacity for loss, but if their attitude to risk is very cautious, then it is likely that their financial targets will need to be re-evaluated downwards. If they did not take their attitude to risk into account it is likely that, should that investment fall in value beyond their comfort level, they would sell before the target end date and realise a loss.

There are a number of different statistical measures that can be used to represent portfolio volatility. Perhaps one of the most relevant to investors when they are considering whether a portfolio may be tolerable to them in the short term – in order that they will continue to hold it for the whole of the anticipated (long) term – is that of Maximum Drawdown. This could be described as a 'worst case scenario' measure.

The Maximum Drawdown measure shows the largest percentage drop the portfolio has experienced over the measurement period – i.e. from peak to trough, ignoring small recoveries along the way. Clearly this may have been experienced over different terms – one or two measurement points (e.g. weeks or months) or a more prolonged decline over a number of measurement points. However, approaching the trough of this market run may be the point at which many investors decide that they can't tolerate any more loss, regardless of the long term strategy, and decide to sell.

The Maximum Drawdown figure will vary according to the measurement point period selected – i.e. is likely to be higher if daily measurement points are used rather than yearly points, as there is a larger set of data to select the maximum and minimum points from.

As an example, the Maximum Drawdown that could have been experienced by an investor using a typical moderate risk portfolio, over the 10 years to April 2025, was around 21% (Q1 2020, the initial Covid lockdown) (source FE Analytics). If this loss is more than the investor could tolerate in the short term without looking to change their strategy, even bearing in mind the longer-term potential return, then this may indicate that the investor has a lower tolerance of investment risk than agreed.

ASSESSING RISK

2. CAPACITY FOR LOSS

Most investment portfolios selected for a given attitude to risk will have a range of possible returns that over or under shoot the expected target return. This range of possible returns needs to be examined to determine whether the lowest expected return is tolerable for the individual – i.e. is within an individual's capacity for loss. An individual's ability to absorb a loss (or a lower than anticipated rate of return), by means of additional savings from income or revision of the target financial goal downwards, will dictate what the acceptable lower boundary will be.

It may be that a low capacity for loss means that the required return figure arrived at below will need to be revised downwards (as generally, a high potential level of return comes with a commensurately high level of risk that this may not be delivered, i.e. the distance between the upper and lower return boundaries are generally increased with the level of risk taken).

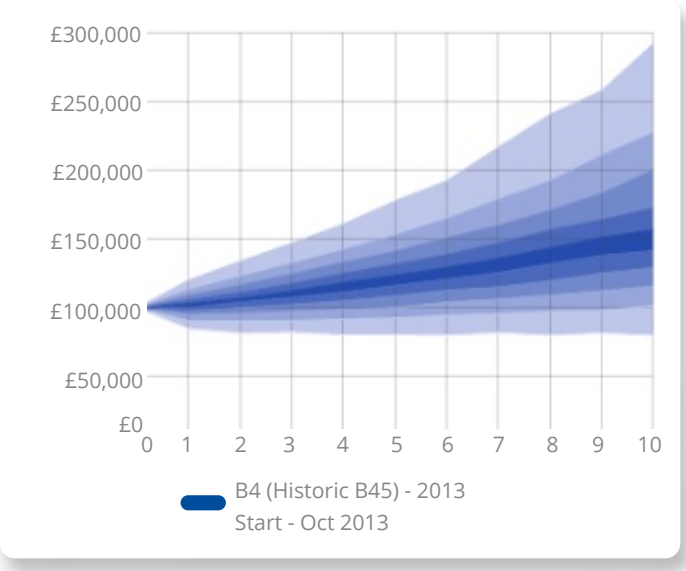
One way that an asset allocation can be assessed for suitability against a determined capacity for loss is by using stochastic modelling to predict the probable range of returns over the investment period. The chart below details a potential range of returns for a moderate risk investor (source FE Analytics 07 March 2025 net returns in future terms). Based on the input assumptions, the stochastic model gives an average expected return, and a range of potential returns above and below this (NB not including any rebalancing during that time).

Assuming a normal distribution of returns (which in itself is debatable), this model shows the returns that might be expected 90% of the time.
Please note the highest and lowest 5% of forecast results are not shown.

These figures may lie significantly outside those plotted on the graph, and even though not shown as they are low probability, may actually be what is experienced with the investment.

The lower potential return shown could be assessed against the investor's overall financial position to ascertain that this does not exceed their capacity for loss. If the investor believes that it does exceed their capacity for loss, then the assessed level of risk, and potentially adjust other variables (such as expected level of return, or target level of savings) may need to be reassessed.

Of course, the results are wholly dependent upon the input assumptions made, and should only be used as a very broad guide to help assess whether the target asset allocation set (and therefore the level of risk assessed) is acceptable to the investor.



Source: Stochastic model provided by EValue.

ASSESSING RISK

3. REQUIRED RETURN

This is the level of return that is needed for the individual to meet their financial goal, based on a number of assumptions such as level of savings made, rates of inflation and tax, timescale etc. Generally speaking, the higher the level of return required, the higher the level of risk (in terms of volatility) that needs to be taken. It can be ascertained by using relatively simple calculators, for example a pension or mortgage calculator, or a 'whole of life' cashflow model can be built by your adviser to take account of various financial goals and constraints as they change throughout life, for example our personalised WealthPlan.

In general, the level of expected return is often an outcome of the assessment of attitude to risk and capacity for loss, as above. It is an unusual investor who decides that they are happy to invest outside their financial or risk tolerance levels to meet a higher required level of return – more often, the investor will need to look at other ways of meeting their goals such as higher savings levels, or reducing the level of the target goal (e.g. income in retirement).

Statistically, half the time the expected level of return will not be achieved, and the other half the time it will be exceeded. Investors, with their adviser, should therefore review the portfolio regularly to ensure that it remains on track to give it the best chance of achieving the target within the acceptable risk framework. In addition, investors' attitudes to risk may change over time – for example decreasing as an individual gets older - and it is prudent to re-examine this periodically.

RISK TRADE-OFFS

Although three separate areas for risk assessment are identified above, in practice, these areas are co-dependent and any mismatches will need to be traded off against each other until an acceptable balance is found.

Investors are clearly more concerned with minimising the downside risk, i.e. the proportion of their funds they could lose, rather than the upside risk, i.e. the level of profit they could make. However, it is critical for the investor to understand that it is often necessary to take risks to achieve greater rewards; it is impossible to have exposure to a high level of upside risk without also being exposed to the equivalent level of downside risk ('too good to be true' usually is!). In this sense risk should be seen as a factor to be taken into every investment calculation rather than a problem.

Any investor would be unhappy with the prospect of losing a significant portion of their investment, but it is a fundamental feature of most investments that some degree of risk must be taken, in order to create the potential to achieve investment returns above the "risk free" rate. Finance theory often uses this risk free rate (usually the return on government bonds) in valuation and optimisation models, but from the investor's perspective an investor unwilling to take any risk would probably place their funds in cash - such as high interest savings accounts – and it is the interest paid on these accounts that could be considered the risk free rate of return.

However, even though an investment in cash will minimise capital risk and volatility, the investor still needs to consider other types of risk such as inflation risk and counterparty risk. It is unlikely that, over the long term, the return on cash will be sufficient to maintain the real value of the cash investment.

Those who are prepared to accept the risk of losing a proportion of their assets in return for potentially greater rewards are more likely to invest in equities. Even here there is a risk spectrum, for example there is a large difference between investing in a fund of blue chip companies in developed Western markets and investing in an emerging markets fund.

The level of risk taken by fund managers is a significant determinant of performance. It is not difficult, with some luck, for a manager to make a high return by betting on a few high risk shares. However, achieving an optimal level of long-term return for a controlled level of risk is a more difficult task.

An investor should look at his objectives and attitude to capital loss when considering attitude to risk. One should consider what one is prepared to lose, not what one would be happy to lose (i.e. nothing), and whether the investment objective set is achievable.

FACTORS AFFECTING RISK

TIMESCALE

The assessment of capacity for loss of the individual investor should take into account the timescale of the proposed investment. A high-risk asset class is one where the value fluctuates significantly – known as volatility – such as with equities. Historically, equity returns over the longer term have generally been less volatile than over short term periods. This is why equity investment is generally not recommended for investment periods under 5 to 10 years, and why the perceived risk of investing in equities diminishes as the timescale for investment grows longer.

For example, Fidelity's research looks back over investment periods since 1994, and shows the highest and lowest returns you may have realised over this period for different investment timeframes. Over a short holding period you can make a lot, but you could also lose a lot. Of course, past performance is not a reliable indicator of future returns, but this shows that a longer holding period has generally meant a lower likelihood of exposure to losses.

Holding Period (FTSE All-Share)	Highest Average Annual Return	Lowest Average Annual Return
1 year	52.30%	-34.36%
5 years	20.34%	-6.58%
10 years	11.18%	-0.68%
15 years	9.88%	3.14%
20 years	8.39%	3.51%

Source: Fidelity/Datastream 31 December 2024, based on daily closing prices, excluding inflation.

FACTORS AFFECTING RISK

TIMESCALE

However, this is not to say that equities are a low risk proposition for long term investment, as the investor will still be exposed to short term volatility at investment and disinvestment (although there are phasing strategies that can be undertaken to average this exposure). In addition, it is important that the investor has the risk tolerance required to see their fund value fluctuate strongly over the shorter term without it causing unease – a common scenario is where the investor sees short term market falls affecting their investment, and sells at a market low, even though their investment timescale is a long term one. This is explored further under the market timing section below.

DIVERSIFICATION

Introducing a suitable level of diversification into a portfolio can optimise the level of risk for a given level of return. For example, an investment in a single share will be fully exposed to the volatility (risk) and return of that one share. However, an investment in two shares, which are equally volatile and have an equal level of potential return, but where the factors affecting volatility are different, will have a lower overall volatility for the same level of expected return. The typical example used in the latter scenario is that of shares in an umbrella company and an ice cream company, which will clearly do well at different times depending upon the prevailing weather conditions.

This relationship between how the shares perform at different times is known as 'correlation', and the basic principle of diversification is to reduce the correlation between investments within a portfolio as much as possible, without reducing the potential return. The principle of diversification applies at all levels, from the top level of deciding exposure to asset classes (e.g. the commercial property market is only loosely correlated with the equity markets), to gaining sufficient diversification within asset classes (e.g. gaining exposure to different geographical and economic sectors, and investment styles).

FACTORS AFFECTING RETURNS

INFLATION - EFFECT ON CASH

The effect of inflation is to continually eat away at returns from all investments. For example, if the UK inflation rate stands at 3%, any investment must generate an after-tax return of at least 3%, in order that the cash sum will have the same spending power a year later. If a bank account paid 5% interest, the real rate of return, in terms of spending power, would be around 2%. If you take income tax into consideration, the net real rate of return would be zero for a higher rate taxpayer, and 1% for a basic rate taxpayer.

Therefore, there is a risk that investing in cash over the medium to long term will reduce the real value of your investment. In reality there are very few 'risk-free' investments', and an investor must think carefully about the level and type of risk they are willing to accept.

INFLATION AND REAL RETURNS

Many investors look at absolute performance over very short terms. However, the figures relevant to the investor are those over the period in which they actually intend to invest, after taking into account the effects of inflation, rather than the gross returns unadjusted for inflation.

The investment market is generally split into four broad asset classes: cash, gilts/bonds, property and equities. The table below illustrates the real annual returns delivered by each asset class, in the UK, over varying periods of time.

Last	2021	10 years	20 years	50 years	122 years
Equities	9.8	4.7	2.9	4.9	4.9
Gilts	-12.6	1.0	2.4	3.0	1.3
Corporate Bonds	-10.0	3.1	2.3		
Index-Linked	-3.1	2.5	3.2		
Cash	-7.0	-2.5	-1.1	0.9	0.6

Source: Barclays Equity-Gilt Study 2022.

FACTORS AFFECTING RETURNS

INFLATION AND REAL RETURNS

Clearly, it is impossible to predict future returns over a specific period by looking at past returns. If much shorter historic investment periods are taken, then returns can differ significantly, as seen with the 10 year figures below.

Period	Equities	Gilts	Index-Linked	Cash
1910-1920	-7.9	-10.8		-6.3
1920-1930	12.8	13.1		9.8
1930-1940	2.3	4.0		-1.2
1940-1950	6.3	0.3		-1.1
1950-1960	12.1	-4.1		-0.6
1960-1970	3.3	-1.4		1.6
1970-1980	0.4	-3.2		-3.1
1980-1990	11.7	6.0		5.2
1990-2000	11.8	9.4	6.2	4.2
2000-2010	0.6	2.4	2.4	1.1
2010-2020	2.9	3.8	4.2	-2.2

Source: Barclays Equity-Gilt Study 2021.

The historic returns on commercial property are difficult to gauge, as there is no recognised index, but the conservative return on "Blue Chip" property is probably at least 3.0% per annum over and above inflation.

FACTORS AFFECTING RETURNS

INVESTMENT TIMING

Long term investors often focus unduly on market timing. Precisely because of short term volatility, it is extremely difficult to 'call' the lows or highs of the market, and we believe that attempting to do so only adds to the risk of investing. This is for a number of reasons, including the following:

- It is very easy to miss the gains. Equity returns are volatile, and this means that sharp falls are often preceded and followed by sharp rises. Attempting to time the market means that it is easy to miss these rallies, which can be a large constituent of overall returns. The table below details the effect of missing the best days over a fifteen year investment period.

- It may not make a large difference to overall investment returns over the long term. When you compare this to the additional risk involved in missing rallies, the potential additional return may well not be proportionate.

		Best Days Missed			
	Fully Invested	**10 days**	**20 days**	**30 days**	**40 days**
FTSE All Share	7.00%	3.88%	1.79%	-0.10%	-1.82%

Source: Fidelity/Refinitiv Datastream, from 31 December 2009 to 31 December 2024, annualised return disregarding inflation. Returns based on the performance of the FTSE All-Share, on a bid to bid basis with net income reinvested.

FACTORS AFFECTING RETURNS

THE FALLACY OF PERCENTAGE RETURN

Take a highly volatile fund - if the fund loses 50% in one year then gains 50% the next many people would assume they have regained their initial investment. That is certainly what many fund groups would like investors to believe.

But on closer inspection the investor has made a substantial loss. If their initial investment were £1,000 a loss of 50% would leave them with £500. And if the fund gained 50% the following year they would be up to £750. Overall they would still have made a 25% loss on their initial investment.

There are numerous variations on this fallacy. The basic problem to be aware of is that investors generally tend to underestimate the impact of compounding on their investments. For instance, bond investors often do not fully grasp the extent to which several years of inflation will erode the capital value of their investment. A more positive example is how investors in shares often underestimate the benefits of a slow but steady increase in the value of their assets, including the reinvestment of dividends, when it is compounded over several years.

TAXATION

Clearly, the relevant rate of return to an investor is that which is received after any tax due on the investment has been paid. Therefore, once an appropriate asset allocation strategy has been set, the next step would be to look at the most tax efficient way to make the investments. When considering tax-favoured investments, the primary consideration is that the investment dovetails with the overall investment strategy. The tax benefits of an investment should simply be an added bonus, rather than the main motivation for investment.

For example, an investor who wanted to put aside £5,000 for school fees in 2 years time should almost certainly not invest the funds in an equity ISA, as the capital would not be secure, even if the ISA wrapper were tax efficient. In this case, the funds would be better placed in a cash style account. On determining this, the investor should then look for tax efficient ways of gaining the best rate, and could then consider a cash ISA for the tax advantages.

THE RESULT OF RISK ASSESSMENT

ASSET ALLOCATION

Asset Allocation involves the process of deciding how to spread an investment between categories of financial assets (including equities, bonds and cash) and tangible assets (including real estate, commodities, precious metals and collectibles). Asset allocation is generally driven by three main factors:

1. The desire to optimise the risk-return trade-off for the desired level of risk.
2. Investment timescale.
3. Other investment objectives, such as a requirement for income or capital growth.

For these reasons, it is impossible to specify a 'one size fits all' asset allocation. The target allocation will depend on the investor's objectives, capacity for loss, and tolerance of risk. However, it is possible to use asset allocation models to set broad parameters which most advisers will use as a starting point when establishing an individual's target allocation.

An asset allocation model only applies to those funds that can be put aside for long term investment. Shorter term spending or income requirements, and a sufficient emergency cash reserve, should be provided for by separate cash savings. In addition, the advisability of any debt repayment should always be considered as a first step.

Once all of the above factors concerning risk and return, and additional factors such as a requirement for a certain level of income, have been taken into account, a suitable asset allocation can beconstructed.

Some models are constructed using optimised historical data; however, historic performance may not be repeated in the future, and almost certainly not over the particular period of investment in question. Some models also use economic predictions to determine suitable allocations. However, these are just that – predictions – and can only be based upon past experience, which again may not be valid over the period in question. Whilst taking on board the validity of some aspects of these methods, we also believe it is important not to forget the investor's individual opinions in setting the target, and coming to a solution that is well diversified, giving exposure to a wide range of investments and is appropriate given the investor's tolerance of investment risk.

Please visit our Risk Profiler for help with setting an initial asset allocation target for your long term investments, or contact us for more advice.

It is important that any target allocation is reviewed periodically, to rebalance the asset classes, and to keep it in line with the investor's attitude to risk and objectives.

Important information: Our views are based upon our understanding of current legislation in England, unless stated otherwise. Levels and bases of, and reliefs from, taxation are subject to change and their value to you will depend upon your personal circumstances.

Risk Warning: The past is not necessarily a guide to future performance. The value of your investment and the income from it can fall as well as rise and is not guaranteed. You may not get back the full amount invested. This document is provided for information only and does not constitute advice. You should not act on any of the information without seeking professional advice.