The Spectrum IFA Group

International Financial Advisers

Guide to Investment Risk

"Now is certainly not the time to have all one's eggs in one basket!"

Introduction to Investment Risk

At Spectrum, we believe clients need to understand contracts, the pros and cons, tax treatment and of course, investment risk.

This guide has been developed by Peter Brooke, one of The Spectrum IFA Group's investment team strategists. In this guide you will find a series of articles about different assets and their inherent risks. The views within this guide are influenced by our internal research, the research from major businesses within the financial services world and from the information gathered during the continuous professional development training sessions all Spectrum advisers participate in.

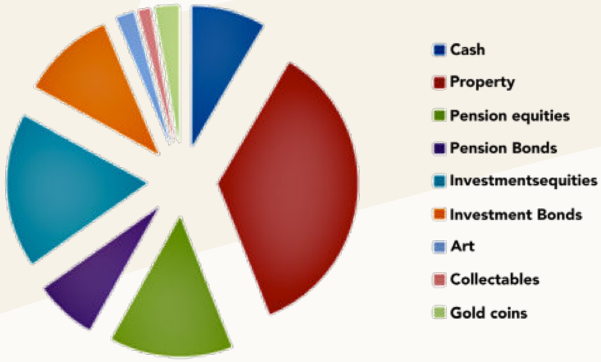
We confess we will rarely suggest particularly adventurous investment strategies: our fund selection process eliminates some of the more exotic investment opportunities and we believe that our clients much prefer to take a safer route.

We will only use daily traded EU listed and EU compliant funds, preferably from top quality, well known and respected fund managers. Where we propose structured notes, usually for a fixed term, these will be straight forward and easy to understand. In both cases, we will not take an initial commission, if one must be paid, we will rebate it in full to our clients.

We all think the concept of loss as being the principle financial risk, but there are different types of risk which can affect the value of our capital and the return we get from it.

I believe risk can be thought of like energy: it is neither created nor destroyed, simply changed from one category of risk to another. If we build an asset portfolio with this in mind, we make sure that we not only understand the likely returns but also the risk profile of each component asset to ensure we aren't taking too much of any one type of risk.

For example a well-diversified portfolio could be broken down as follows:

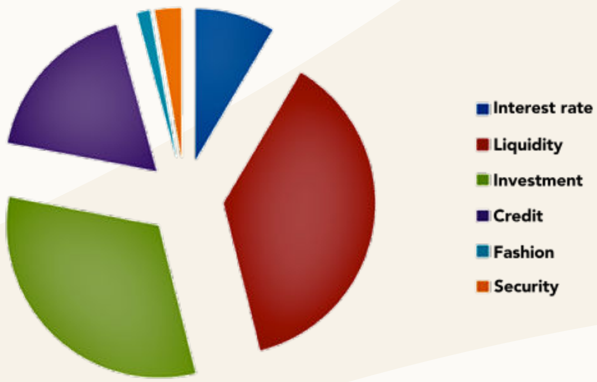


But if we look in detail at the risk, there may be too much of any one type, for example liquidity risk or investment risk, and more diversification could be needed.

Diversified portfolio

ASSET	VALUE	RISK TYPE
cash	60000	interest rate
property	250000	liquidity
pension equities	100000	investment
pension bonds	50000	credit
investment equities	125000	investment
investment bonds	75000	credit
art	15000	liquidity
collectables	10000	fashion gold
coins	20000	security

So let's look at each type of investment asset and the associated risk considerations:



Peter Brooke
The Spectrum IFA Group
Investment team strategist

Bank accounts and cash

The safest form of investment asset is considered to be cash, but what are the risks of a loss if I hold money in my bank account?

Counterparty & jurisdictional risk – if my bank (my counterparty) goes bust, the French (my jurisdiction) government will currently underwrite the first €100,000 of all individual deposits. If I bank with a big name in a well-protected jurisdiction I should be OK, but should I move the excess to another bank to reduce risk?

Inflation risk - with time, the cost of goods and services tends to increase; this eats away at the real value of money or its buying power.

Long term global inflation is approximately 2.5% p.a. But that's not the whole story, as inflation is based on an average 'basket of goods and services'. At different stages of our lives, the importance of elements within that basket can vary: the cost of living might drop for a family with a mortgage when interest rates fall, but an elderly couple with food and fuel bills and no mortgage feel the pinch as oil, coal and food prices rise.

Interest rate risk – the bank pays me interest on my money, lends it out at a higher rate and pockets the difference as profit. If interest rates are high, I am taking the risk that my return may fall. Can I get a better return for similar risk elsewhere?

If interest rates are low, as they are today, then I am swapping interest rate risk for inflation risk by having my money in a bank account. It is the amount of my return over inflation that I need to consider when looking at the amount of risk I am willing to take. Today, if I am lucky enough to earn 0.5% interest, it means I am losing 2% per year in real terms … guaranteed.

Default risk – the bank should continue to pay me the interest as it receives it from its lenders. There is a small risk here if I choose a weaker bank.

But by banking my money I am NOT taking the following risks:

- *Liquidity risk* – I can get to my money anytime.
- *Investment risk* (volatility of returns) – my money is just in a bank account; the interest may change a tiny amount, but the capital value remains stable (except for inflation).
- *Opportunity risk* – as my money is not tied up, I can use it to take advantage of buying opportunities that come along (once I understand the risk/return swap).

Bonds

The term bond is broadly used by the finance industry; here we concentrate on the investment assets often known as fixed interest, fixed income, or debt securities. Government bonds have their own specific names too, for example UK gilts, US treasury bills (T-bills) and German bunds.

If a company or government needs to raise money and does not want to (or can't) issue new shares or borrow from a bank, they may issue a bond. It promises to repay the bond holder the face value on a set date in the future and until then will pay interest for the loan (the coupon). Bonds are issued on the 'issue date' but can be freely traded on the bond market so their price can fluctuate with normal market conditions. The fluctuation in price means that the yield changes too.

> *Example: 4% Treasury Gilt 2022 was issued in February 2009 at £100 per gilt. It promises to pay back £100 in March 2022 and will pay £4 per gilt every year to the holder.*
> *Today the value of this gilt on the open market is £107.20; if you hold this gilt you will still get £4 as a coupon; this means the yield is now 3.73% and not 4%.*

When a company is wound up (in the event of bankruptcy) the bond holders, as creditors, are repaid from the assets of the company before any shareholders; this means that bonds are considered safer to hold than shares. The coupon must also be paid before any dividends. So, what risks should we consider before buying bonds?

Default risk – can the bond issuer repay me my coupon every year and can they pay me back at the end of the term?

Interest rate risk – as interest rates go up, bond values fall (and vice versa). In a low interest rate environment, are we exposing the value of our capital to risk if interest rates are increased?

Market risk – these are investments, and though considered safe, a flow of money out of the bond markets because of lack of confidence can affect prices.

Issuer specific risk –a lack of confidence in the future of the company can, like shares, create a selling of the bonds too.

Liquidity risk – if buying smaller company or peripheral government bonds, it can be tricky to sell them should you need to quickly. This is due to a lack of counterparties wishing to buy them.

Safety vs risk – at the moment, developed government and many blue chip company bonds are trading at record low yields, and though they are considered safe (as they are unlikely to default) this doesn't mean they are without risk. If a bond has a yield of 1.5% and interest rates go up by 1% it is possible to lose 10% of the capital value - this is now not low risk.

Buying bonds through a fund can help reduce many risks. The fund manager will choose which sectors to invest in and can manage the specific risks appropriately. We favour global strategic bond funds as they have a very broad remit and a very large bond universe to invest into.

Property

In Europe we tend to have a bit of an obsession with owning property; it is an important part of our culture and we feel secure in the knowledge we own real estate.

It is understandable why owning your own home is a very good idea (control of what it looks and feels like, feeling of 'home', long term outlook etc.), but I believe that many people will tend not to look at all of the basic investment factors when selecting a property to buy (to live in or as a pure investment), including risk.

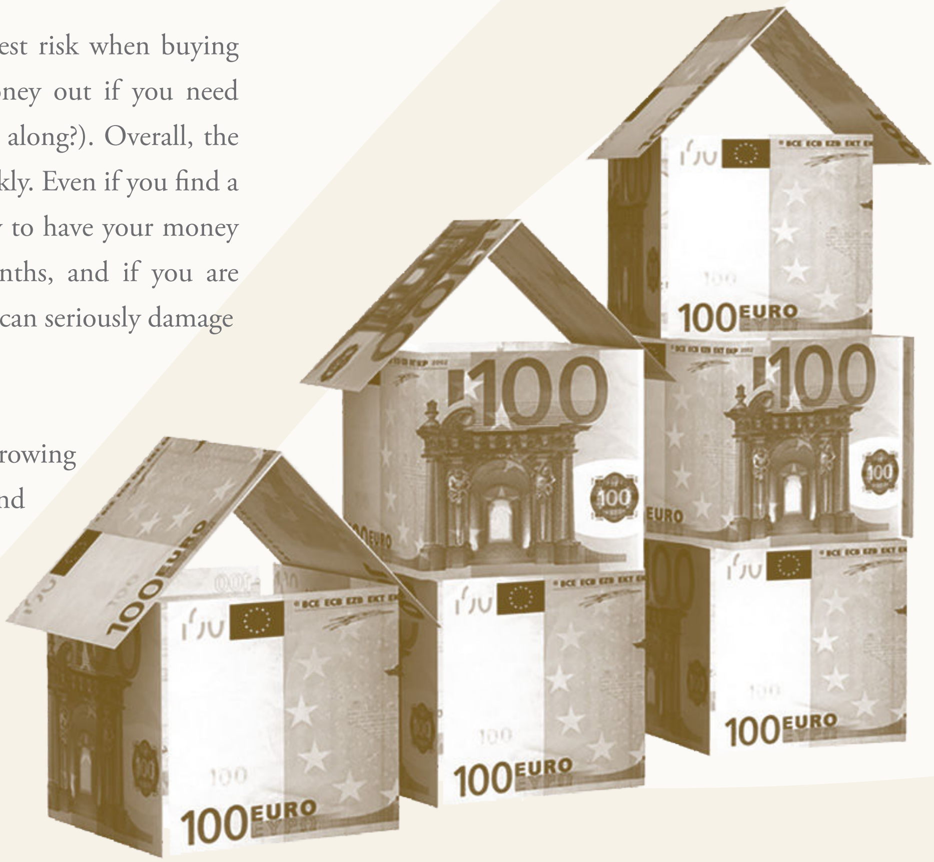
Of course, location (location, location), price, quality, taxes and maintenance costs are normally considered by potential investors, but for some reason many investors tend to believe that property is in some way risk free. Like all investments, we should 'buy with our heads' and 'sell with our hearts'. Too many of us get this the wrong way round and ignore some of the issues, which can cost us dearly. Let's look more closely at the property specific risks.

Liquidity risk – the single biggest risk when buying property! Can you get your money out if you need to (or if something better comes along?). Overall, the answer is 'no', or at least not quickly. Even if you find a buyer tomorrow you are unlikely to have your money back money back within 3 months, and if you are looking for a quick sale then you can seriously damage your return by taking a low offer.

Interest rate risk – if you are borrowing to buy, as most people do (and probably should), then there is a risk that your cash flow will be affected and the total cost of your property over its lifetime could go up dramatically if interest rates move.

Market/investment risk – as we saw in 2008, the price of property can fall as well as increase. Again, many investors feel that property is in some way a rock solid investment, guaranteed to make money. Like all other forms of investment asset, this is only true if you buy the right property, in the right place, at the right price. When property markets crash, they tend to do so heavily and take a longer time to recover than more liquid markets.

Tax/governmental risk – one of the easiest assets to tax more in times of economic strife are properties, especially those owned by investors (as they tend to be easy political targets). Increases in local rates and taxes on property are easy to push through and raise significant sums for governments.



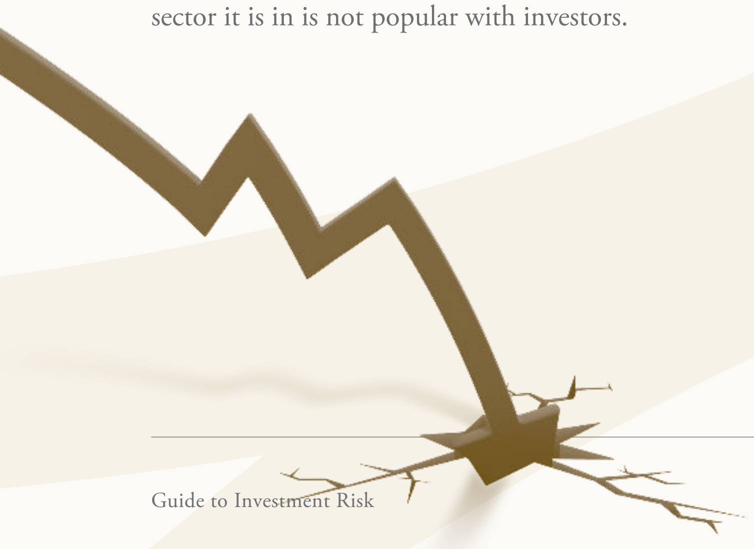
Equities

Equities are also known as stocks or more commonly shares, because they are a 'share' in a company. As a part owner of that company we must therefore share in its profits (and losses).

If the company that we have invested into goes bust, we share in this and lose (normally) everything we put in. Likewise, if it is very profitable then we would hope to be rewarded, as owners should be, by dividend, share price growth or both. The performance of shares is well documented and on average they outperform most other assets over the long term, but do we really understand all of the different types of risk we take on as investors in shares?

Asset risk – if equities themselves, as an asset class, are out of favour then they tend to all fall together when concerns about future growth (and therefore profits) are prevalent. The concerns may be irrelevant for the market or sector you are looking at, which could have robust fundamental reasons to invest in it, but it can still be knocked by the market selling off all equities.
Market or correlation risk – many major stock markets are very highly correlated, so even if you have a diverse portfolio of, for example, European, US and UK shares, you can lose value on all of them if they are highly correlated.

Sector risk – companies all do different things, provide different services and make different goods, but sometimes a whole sector will be out of favour, so losing value in what is a good company may still happen if the sector it is in is not popular with investors.



Company specific risk – this is primarily down to the quality of the board of the company and the vast majority of company directors want their companies to do well, but their share price can also be affected by regulatory changes, legal actions, competitors, patents etc. No matter how good a company may be, it is not immune from difficulties and so different companies will perform better in different parts of the market cycle.

'Shares are the only things we don't buy on sale'

Liquidity risk – if you decide to buy smaller companies which aren't very well known, then there may be a minimal market for them. This means that if you can't find a buyer, then you either can't sell them at all or you accept a lower price. Most shares are traded on regulated stock exchanges and so the liquidity of all but the smallest companies is generally good.

Shares are the only things we don't buy on sale, so all of the above risks, as with most assets, can create buying opportunities. It is often best to access shares via funds, so the daily choices and control are managed by a professional manager. You can then also access many different sectors and markets with a relatively small portfolio.

It is vital to understand the different types of risk so your overall asset base is not over exposed to one type of risk. For example, someone with a large property portfolio (liquidity risk) shouldn't then invest in small companies but should have more money in cash (inflation risk), high quality bonds (interest rate risk) and blue chip shares (market risk).

Precious metals

All that shines... many metals and jewels make pretty attractive investments in various ways, but each has their own risk factors. When buying into metals, decide whether you are buying as a pure investment or as a useable investment as this will affect performance and risk.

The main ways to buy into metal and jewels are:
Direct – bullion, coins, jewellery etc. Even within this sector the choice is huge. If you want pure investment, then buy as close to the raw materials as you can. There are many different mints of coins, but some are as collectables and some as investment.
Indirect – this is an exposure to the price of the underlying metal. Many people buy into precious metals via Exchange Traded Funds (ETFs) but be wary of some of them.

So what risks are you taking by investing in the shiny stuff?

Asset risk: – the prices of these assets and therefore the value of your holding can be hugely affected by global political/economic events (e.g. quantitative easing) as well as the fundamentals of supply and demand.

Theft/security risk – if you decide to buy directly then you must consider the security of your coins or bullion and the cost of securing them. You probably do not want to have $10,000 worth of gold coins under your mattress.

Liquidity risk – selling directly held coins can take time. Normally, if they are highly traded newly minted then liquidity should be good, but collectable coins could take time to find a buyer or suffer a price fall.

Fashion risk – collectable coins/ jewellery are fashion sensitive and not directly linked to the price of the material they are made from. Be careful, they normally trade at a big discount or premium to the underlying material.

ETFs: real or synthetic – some ETFs buy the underlying commodity and hold it in trust for the investors in the ETF. If you sell your holding, generally, the ETF will sell the actual metal. Other ETFs use rolling forward contracts or other derivatives on the underlying commodity via an investment bank. This means that most of the time the price will move with the underlying metal price, but not always. This was seen with the paper gold price falling dramatically, but the real gold price continued to trade above the paper price.

Counterparty risk – synthetic ETFs are collateralised by an investment bank; if this collateral is of low quality (very possible) then you may risk the bank being unable to return money if something goes wrong.

Generally precious metals held directly or indirectly (through a real asset ETF) are excellent additions as a small proportion of a portfolio. We have seen huge volatility in prices in the last couple of years and so we must not be over exposed to metals and stay aware of the above risks. Also, like all investments, have a strict profit taking discipline when the values look good.

Investment structure *- the unconsidered risks*

As we have discussed in this guide, there is a lot to think about with respect to risk, be it for cash, bonds, equities, property, commodities or alternative investments.

What is often not discussed enough by financial advisers and their clients are the structural risks of buying into an investment scheme. It is important to ask your adviser about the all the risks to your capital, not just to what can happen to the value through poor investment performance, which will always happen from time to time.

Policyholder protection – in Europe, many investment schemes are set up via insurance policies. These often have significant tax advantages and offer levels of policyholder protection not provided by banks or investment/brokerage accounts or platforms. The insurance company model means that a life company is always required to hold all the assets underlying its clients' policies, plus an additional amount of its own capital for a solvency margin. This means that if the insurance company is put into liquidation, then the client assets are ring fenced and the company can pay for all of the costs of transferring the 'book of business' to another insurance company or to return 100% of the assets to its policy holders.

The better the jurisdiction in which the life company is based, the stronger the regulation tends to be and the more capital it must have; therefore, the less likely it will be become insolvent anyway. In nearly all cases, big is beautiful when it comes to insurance companies.

Credit rating – when it comes to financial institutions, it is important to understand the solvency of that financial institution ie. how likely it is to meet its financial obligations. This is often measured via a credit rating from one of the rating agencies. For example, S&P ratings are AAA, AA, A, BBB, BB, B, CCC, CC, C and then D, where AAA is 'extremely strong capacity to meet financial commitments and D is 'defaulting on financial commitments' (source www.standardandpoors.com/ratings).

Custody – many life companies and investment platforms add another tier of protection by using a third party custodian, which avoids conflicts of interest and helps segregate your assets from those of the company. Find out who is actually holding your assets and why.

Investment fund structure – very careful consideration should also be given to the actual structure of the investment fund that you choose. There are approximately 80,000 collective investment funds in the world and where they are registered and how they are regulated can vary enormously.

Considerations include:

1. *Liquidity* – daily priced is best for being able to get money out.

2. *Regulatory structure* – look for SICAV, UCITS, OEIC etc. This ensures a strong regulatory reporting requirement about all aspects of the funds.

3. *Ratings* – if possible, check that the funds you are thinking of buying have been highly rated by at least one or two independent rating companies (Morningstar, Financial Express, S&P etc).

4. *Check the fact sheets of the funds carefully for SIF, EIF or QIF* – these are specialised, experienced or qualified investor funds. They are often sold inside insurance policies but rarely come with the required disclaimer that you, as the investor, must sign confirming that you consider yourself an 'experienced or qualified investor'. Over the last few years many of these types of funds have suspended

trading leaving normal retail clients, who shouldn't have been allowed to buy them in the first place, stuck in portfolios they cannot access.

If in doubt, check any advice or your own investment ideas with a fully regulated adviser, or preferably two. Oh, and check the adviser's regulatory position too!

Peter Brooke joined the finance industry in 1998 and spent five years in London advising clients on how to address the balance, structure, and performance of their investment portfolios. He has been with Spectrum since 2004, based in France where he has his own client base and has been instrumental in developing and monitoring investment solutions for our Spectrum advice team and our clients.

Peter is an Honours graduate of the University of Sussex and, and holds the UKSIPP Investment Management Certificate and Chartered Institute (CII) Financial Planning Certificate.

"As an International Financial Adviser, The Spectrum IFA Group is able to offer financial planning advice in relation to insurance, investments, pensions, tax and estate planning, currency transfers"

Discussing investment risk

When talking to clients, financial advisers are required to discuss investment risk. There are many risk profiling tools available for advisers to help them understand a client's attitude to risk and ability to take risk, but what happens next?

As Peter has alluded to in this guide, there are many more complexities today when selecting assets for investment. When I joined the industry, understanding risk was much easier.

Cash in the bank was considered low risk or even no risk at all. Government bonds were considered slightly higher up the risk scale and equities (shares) were higher risk again. Property was not considered risky and gave its name to an English expression, 'safe as houses'.

In 2008, everything changed. Banks failed, governments were under financial stress, stock markets fell. Do these events mean advisers should tell clients everything is high risk?

Banks are being recapitalised and in the European Union, governments guarantee the first €100,000 of a bank deposit. There are two caveats to this,

1/ not all accounts carry the guarantee and 2/ the guarantee is by banking group, not individual bank. If a depositor has money in two banks but they are part of the same group, then only €100,000 is protected.

We are all feeling better about the strength and security of banks, so that is the good news. What about the deposit rates we are being paid? Is there an inflation risk we should be concerned about? If inflation is running at a rate greater than the deposit interest we are being paid, we are losing money in real terms, aren't we? £100,000 in 2009 is worth £84,000 today!

Is it, therefore, always sensible to hold government bonds? What happens to bond values if interest rates rise? Is there a risk the value of bonds could fall?

We have seen volatility in equity markets with some large companies having financial difficulties. At the same time, some companies are doing very well, are cash rich and are paying good dividends.

Regulators tell advisers we need to understand our clients' attitude to risk and provide solutions to our clients that match those attitudes. The regulators do not yet tell us which asset classes represent high risks or low risks. Is it therefore good advice to tell a cautious investor to leave their money on deposit at a bank? Almost certainly not. How do we advise a client who wants no risk and a return more than inflation? It's not an easy job.

Our feeling is that the best advice we can offer is to spread the risk, diversify in terms of asset classes, pay attention to liquidity, and fully understand any product or portfolio. Now is certainly not the time to have all one's eggs in one basket!

With more than 50 advisers working from 12 offices in seven European countries, Spectrum is one of the largest, English speaking, expatriate focused, cross-border financial planning firms of its kind.

For further information please visit our website or email info@spectrum-ifa.com

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