

# What's your risk level?

How you feel about taking risks will influence your choice of goals and objectives when it comes to investing, says Ray Prince



Your risk profile comprises both attitude and capacity

Sensible investment and wealth management requires a balance between your risk profile and investment portfolio volatility. Both of these factors can be combined to make up your investment policy and investment philosophy. Interestingly, all large company pension schemes have investment philosophies, and we believe it's sensible that all investors should too.

It's important to understand that your risk profile is comprised of two aspects: your risk attitude and your risk capacity. Risk attitude is the true measure of your personal comfort with risk. For example, are you willing to risk a less favourable outcome while attempting to achieve a more favourable one? (risk v return).

## Protect your assets

Risk capacity is your ability to sustain a less favourable outcome without jeopardising your original goals and objectives. Risk capacity is affected by factors such as time horizon (allowing you time to recover from an adverse return) and total wealth (allowing you to go through a decline in account value and still maintain your desired spending).

The two areas are as important as each other and it is vital that you take both into account when making important investment decisions. For example, if your risk attitude means that you could sustain a 25 per cent market decline without any impact on your goals, the appropriate portfolio may contain 60 to 80 per cent equities.

However, if your risk attitude measure indicates that any decline in excess of 10 per cent would cause you cold sweats and sleepless nights, then the 60 to 80 per cent equity portfolio is clearly not the right approach. Instead, you should be invested into a portfolio with a lower percentage of equities.

## Average return figures

Between 1988 and 2007 the average annual returns from some example portfolios have been:

- 100 per cent equity, 11 per cent pa growth, biggest fall in one year 29.5 per cent
- 80 per cent equity 20 per cent bond, 10 per cent pa growth, 23.5 per cent fall
- 60 per cent equity 40 per cent bond, 9.5 per cent pa growth, 17.2 per cent fall
- 40 per cent equity 60 per cent bond, 8.7 per cent pa growth, 10 per cent fall
- 20 per cent equity 80 per cent bond, 7.8 per cent pa growth, 3.6 per cent fall
- 100 per cent bond, 6.9 per cent pa growth, 3.4 per cent gain (no fall)

Source: Dimensional Fund Advisers Matrix Book 2008

## Building your profile

So, how can you ascertain your full risk profile? There are two keys. First, you must obtain a true measure of your risk attitude. This can be obtained by using a comprehensive risk-profiling system. You won't be able to achieve this by second-guessing it yourself, as it's highly unlikely you'll know enough for the assessment to be successful. You should speak to your financial adviser/planner and ask them what they're using.

One of the most comprehensive tools is provided by FinaMetrica, [www.finametrica.com](http://www.finametrica.com). Its assessment contains 25 questions and your score (1 to 100) will be compared against a pool of approximately 20,000 others that have completed the questionnaire. You should then make sure you interpret the score correctly and are able to act upon the information effectively.

Secondly, you should work through a process of financial planning to determine your true goals and objectives. This step is crucial. Without it, how will you know what your tolerance is for risk capacity (for example, how will you know how much loss you can absorb without it affecting the likelihood of you achieving your goals)?

Once you know how much downside you can tolerate, you can then determine what the appropriate

investment policy should be, using risk attitude as a constraint. This should lead you towards deciding what percentage of equities you are comfortable with in your portfolio (you should be able to alter this percentage in future years).

The alternative approach is that you remain invested in a higher percentage of equities, but be prepared to adjust your goals (retire later, spend less, spend more, for example) if the portfolio value falls too much. Of course, you may reach your goals sooner if the higher-risk portfolio grows at a faster rate than the lower risk portfolio!

## The bottom line

When you break it all down, it's more than likely you're trying to achieve your goals and objectives in *some* form. And most people would rather try and reach their goals with the minimum amount of risk (note I said some people – there'll always be the risk-takers among us).

## The next step

The subject of investment risk should not be underestimated. If all you've done up to now is assess your risk on a scale of 1 to 10 (and believe me, this is very common), maybe it's time to take a more comprehensive approach? After all, it's only going to improve your understanding of your own risk tolerance and how much risk you can afford to take.

## Free audio CD

To learn more about risk and your retirement planning options, you can request a free copy of one of Rutherford Wilkinson's audio cds: *How To Avoid The Three Most Common Retirement Planning Mistakes*. Just call Catherine Lowes on 0191 217 3340 and a copy will be posted to you (please quote ref: DT).

## About the author



### Ray Prince

is an impartial financial planner with Rutherford Wilkinson plc and helps dentists achieve their financial objectives, as well as getting the best deals on mortgages, protection and investments. Call 0191 217 3340 or email [ray.prince@rwplc.co.uk](mailto:ray.prince@rwplc.co.uk)

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