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Understanding risk

What risk should you take with your money? Work through our three steps to understand your risk appetite – it will help you choose the best homes for your money.

What is risk appetite?

Saving and investing involves a variety of risks, for example the risk your money will not keep up with rising prices (inflation risk), the risk that comes with share prices going up and down (volatility risks), the risk that an institution will fail (default risk), and the risk that you could have earned better returns elsewhere (interest-rate risk).

The trick is to strike a balance between these different risks. What is good balance for you will depend on:

- your personal circumstances - how much you can afford to lose (your capacity for loss)
- your investment goals, time frame and need for returns
- your personal attitude to risk

Taken together these make up what's called your 'risk appetite'. Of these three things your capacity for loss and your investment goals are most important. Personal attitude to risk is hard to measure and can be changeable, what feels comfortable one day may not the next.

How financial advisers assess your risk appetite

A financial adviser should always assess your risk appetite and circumstances before making any recommendations.

Investment advisers and financial advisers must assess your risk appetite before making any recommendations. Some use risk-attitude questionnaires, but remember it is your capacity for loss and the nature of your investment goals that are most useful in determining a good balance of risk for you.

How to assess your risk appetite

Use the following steps to get an idea of your risk appetite.

Step 1 - Know what you can afford to lose

Ask yourself what would happen if you lost some or all of the money you're putting into investments. This will depend on your circumstances and how much of your money you're investing.

Think about people who depend on you financially and any other important financial commitments you need to be sure of meeting.

Step 2 - Work out your goals and timings

Your saving and investing choices will depend on your goals and timescales. The bigger your goal in relation to the assets or income you wish to invest, the greater the rate of return required to beat inflation and hit your goal. Taking no volatility risk at all may make your goals impossible to achieve, taking too much may lose you your investment.

Short-term goals – under five years – such as a car or a house deposit are best saved for in cash. If you have a short-term goal your appetite for volatility risk would usually be low and cash products will be the best place to invest. You don't want to be worrying about the state of the financial markets when you need your money to be readily accessible. However, cash savings run the risk of not keeping up with rising prices (inflation risk)

With **longer-term goals**, it's more usual to put your money into investments that have a better chance of giving you inflation-beating returns, such as shares, but which carry the risk of prices going down. A longer time frame gives your investment more time to recover if it falls in value. So if you have a long-term goal it makes sense to be prepared to take on volatility risk for the opportunity of higher returns.

As long-term goals move closer

However, as a **long-term goal moves closer** the risk balance should change. For example, you may want to start moving into less volatile assets a few years before the goal date, to start 'locking-in' gains, and to protect your investment against events like market falls.

At any one time you may have a mixture of short-term or critical goals for which you want low volatility (such as saving up to move house), and some non-critical or long term goals for which you have a higher appetite for volatility (for example, saving into a treats fund, or saving towards retirement) that may bring higher returns.

Step 3 - Understand your personal risk attitude

A good way to manage risk is to spread your money across a range of different investment types.

Risk attitude is subjective and is likely to be influenced by current events or recent experiences. When stock markets are rising we tend to feel comfortable with market risk, when they are falling we do not. Most people are not comfortable with the idea of losing money. On the other hand we may regret it if we've been very cautious and our long term investments don't produce the returns we need.

You can keep risks in line with your risk appetite by spreading your money across a range of different investments.