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ManningGee Investments

Sustaining Wealth and Trust

What Does "Investment Risk" Actually Mean? A Plain-English Explanation

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Introduction

We are now halfway through our financial education series.

Over the next three guides, we are going to explore investment risk, market downturns and how to make decisions when the future feels uncertain.

This guide starts with a simple but important question:

What does investment risk actually mean?

Risk is not simply whether investments move up and down. It is the possibility that your money does not support the life and goals you are planning for.

Consider two people experiencing the same 10% fall in the value of their investments:

- One sees it as a temporary setback.
- The other fears losing everything.
- One may need the money next year.
- The other may not need it for another 20 years.

The market movement is the same, but the effect on each person could be very different.

This is because investment risk is personal. It depends on:

- What the money is intended to achieve.
- When it will be needed.
- How much loss you could financially withstand.
- How you are likely to react when markets become uncomfortable.

The objective is not to remove all uncertainty. That is impossible.

Instead, it is about understanding which risks you are taking, why you are taking them and whether they are appropriate for your financial plan.

The aim is not to avoid every risk. It is to take the right risks for the right reasons.

Investment Risk Is More Than Volatility

The words risk and volatility are often used as though they mean the same thing.

They do not.

Volatility describes how much the value of an investment moves up and down over time.

An investment that experiences larger and more frequent price movements is normally described as more volatile. This may make the journey feel uncomfortable, but it does not automatically mean the investment will fail to achieve its long-term purpose.

Think of volatility as movement during a journey.

A difficult or uneven part of the journey does not necessarily mean you will fail to reach the destination. However, it may test whether you are prepared and able to continue.

A diversified investment portfolio will fluctuate. These movements can be uncomfortable, but it is important to distinguish between two different situations.

A Temporary Decline

The investment falls in value but has time and the potential to recover.

Recovery is never guaranteed, but a short-term fall does not automatically mean the long-term plan has failed.

A Permanent Loss

A permanent loss may occur when:

- An individual investment fails.
- The original investment was unsuitable.
- Money must be withdrawn after a fall and before there has been an opportunity to recover.
- An investor sells because of fear and does not participate in a later recovery.

When an investment falls, the lower value is real, even when the investment has not been sold.

However, selling after a fall crystallises that loss. This is why your timeframe and behaviour are so important.

The Different Risks Investors Face

It is easy to assume that all investment risk comes from markets falling.

In reality, investors face several different risks.

Market Risk

Market risk is the possibility that investments fall in value because of factors such as:

- Economic conditions.
- Company performance.
- Interest rates.
- Inflation.
- Political events.
- Changes in investor confidence.

Market movements are a normal part of investing. They cannot be predicted or controlled with certainty.

Inflation Risk

Money held in cash may appear safe because the account balance does not normally move up and down.

However, inflation can gradually reduce what that money can buy.

When prices rise faster than the interest earned on savings, the balance might increase while its spending power falls.

This does not mean cash is unsuitable. Cash plays an important role in a financial plan. The risk comes from expecting cash to meet objectives for which longer-term growth may be needed.

Shortfall Risk

Shortfall risk is the possibility that your money does not grow sufficiently to achieve your objectives.

This could mean:

- Retiring later than planned.
- Having to reduce your retirement income.
- Having less available to support children or grandchildren.
- Saving considerably more than expected.
- Running out of money later in life.

An investment strategy that experiences very little movement may feel comfortable, but it could still be risky if it is unlikely to provide the growth required.

Timing Risk

Timing risk arises when money must be withdrawn shortly after investments have fallen.

This is particularly important when approaching or living in retirement. Regular withdrawals during a market downturn can reduce the capital available to benefit from a later recovery.

A financial plan can help manage this risk by considering:

- Emergency savings.
- Planned expenditure.
- Appropriate cash reserves.
- The timing of withdrawals.
- Which assets should fund short-term and long-term needs.

Behavioural Risk

Behavioural risk is the possibility that emotions lead to decisions that damage the financial plan.

An investor may have a suitable, diversified portfolio but still experience a poor outcome if they repeatedly buy, sell or change direction in response to headlines and short-term market movements.

In some cases, our reaction to risk can become more damaging than the original market fall.

Your Timescale Changes the Meaning of Risk

Time does not remove investment risk and investing for longer does not guarantee a profit.

However, a longer timeframe can provide more opportunity for an investment to recover from periods of weaker performance.

Money that may be needed soon should therefore be treated differently from money intended for a goal decades into the future.

A broad starting point might look like this:

When the money may be needed	Main consideration
Within the next few years	Access and stability may be particularly important
Over the medium term	A balance between growth and stability may be appropriate
Over the longer term	Greater exposure to growth assets may be possible

This is not a recommendation or a rigid formula.

The appropriate approach will also depend on your circumstances, objectives, existing financial resources and capacity for loss.

Consider two people who each receive £20,000.

The first intends to use the money as a house deposit in two years.

The second intends to invest it towards retirement in 20 years.

The amount is identical, but the purpose and timeframe are different. As a result, the appropriate level of investment risk may also be very different.

Before deciding how to invest, it is important to understand when the money might be needed and what it is expected to achieve.

The Risk of Doing Nothing

Avoiding investment risk does not mean avoiding every type of risk.

Holding money in cash can feel reassuring because its value does not normally fluctuate in the same way as investments.

However, someone who remains entirely in cash for a long-term objective may face other risks, including:

- Inflation reducing spending power.
- Falling short of retirement goals.
- Having to save significantly more.
- Delaying retirement.
- Taking more investment risk later because insufficient growth was achieved earlier.

Cash is not bad.

It has an important role in providing:

- Emergency funds.
- Money for planned expenditure.
- Access to funds needed in the short term.
- Stability and reassurance.
- A reserve during periods of market uncertainty.

The issue is not holding cash. It is expecting cash to meet every short-term and long-term objective.

Sometimes, the decision that appears safest today can create a greater financial risk in the future.

How Much Loss Could You Afford?

People sometimes focus on how much investment risk they are willing to take without considering how much they can afford to take.

These are different questions.

When discussing investment risk, three areas should normally be considered together.

Attitude to Risk

This describes how you feel about investment uncertainty and falls in value.

Would a 10% or 20% fall cause you to worry? Would it make you want to sell, or could you remain focused on the longer-term objective?

Capacity for Loss

This describes the financial effect that a fall in value could have on your lifestyle and plans.

Could you withstand the loss without affecting your essential expenditure, retirement plans or financial security?

Someone may feel comfortable taking considerable investment risk but have a limited capacity for loss because they need the money soon.

Another person may dislike volatility but have a longer timeframe, secure income and substantial financial reserves.

Need to Take Risk

This considers how much investment growth may be required to achieve the objective.

Some people may not need to take a high level of risk because they already have sufficient resources.

Others may discover that their objectives require more growth than a very cautious strategy is likely to provide. This does not mean they should automatically take more risk. It may mean reconsidering the objective, timeframe or amount being saved.

These three areas do not always produce the same answer.

This is why we believe a risk questionnaire should start the conversation rather than replace it.

A score cannot fully understand:

- Your family.
- Your future plans.
- Your income needs.
- Your previous experiences.
- How you might respond during a market fall.

The discussion around the answers is often more important than the final score.
This is particularly relevant when considering speculative investments.

A useful question is:

If this investment failed completely, what would it mean for my life and financial plan?
When the answer is that you cannot afford to lose the money, that may provide the answer you need.

Why Our Emotions Can Become the Greatest Risk

We are human.

When markets fall and headlines become worrying, it is natural to want to do something.

Unfortunately, investors sometimes make their most damaging decisions when they believe they are protecting themselves.

Selling After Markets Have Fallen

Selling may turn a temporary decline into a crystallised loss.

The investor may then remain in cash while waiting for conditions to feel safer, only to miss some or all of the recovery.

Waiting for Certainty

There is always a reason to delay investing:

- An election.
- A conflict.
- A possible recession.
- High inflation.
- Falling markets.
- Markets reaching record highs.

Complete certainty rarely arrives. By the time the outlook feels comfortable, markets may already have moved.

Chasing Recent Winners

Strong recent performance can make an investment look attractive.

However, buying only because something has recently performed well can mean investing after prices and expectations have already risen.

The investment may also be more concentrated or speculative than the investor realises.

Changing Strategy Repeatedly

Moving between funds, investment styles and cash can prevent any strategy from having enough time to work.

It may also result in buying after markets have risen and selling after they have fallen.

Good investing is often less about predicting what markets will do and more about managing how we respond.

How Financial Planning Can Help Manage Risk

Financial planning cannot prevent markets from falling.

What it can do is help you prepare for difficult periods before they happen.

A financial plan can help by:

- Giving each pot of money a clear purpose.
- Matching investments to the appropriate timeframe.
- Maintaining emergency and short-term cash reserves.
- Diversifying across investments, asset classes and regions.
- Testing whether your goals remain achievable.
- Reviewing changes in your circumstances.
- Planning how withdrawals will be funded.
- Providing a calm second opinion when markets become uncomfortable.

The aim is not necessarily to select the investment with the least movement.
It is to create a strategy that you understand, can financially withstand and are able to remain committed to.

The right investment strategy is not simply the one that looks best when markets rise.
It is one you can stay with when investing feels difficult.

Questions to Ask Before Investing

Before investing, it may help to ask:

1. What is this money intended to achieve?
2. When might I need access to it?
3. How would a fall affect my lifestyle or plans?
4. How would I feel if the value fell by 10%, 20% or more?
5. Do I have sufficient cash for emergencies and short-term spending?
6. Am I investing in a suitably diversified way?
7. Do I understand what I am investing in?
8. What might cause me to abandon the strategy?
9. Who will help me make decisions when emotions are running high?

These questions do not remove risk, but they can help make it more understandable and manageable.

Conclusion: Risk Must Be Understood, Not Feared

Investment risk cannot be eliminated.

The important points to remember are:

- Volatility and permanent loss are not the same.
- Time can help manage short-term uncertainty, but it does not guarantee a return.
- Holding too much cash can create different risks.
- Your attitude to risk and capacity for loss are not always the same.
- Behaviour can sometimes cause more damage than markets.
- Risk should always be considered in relation to your goals and wider financial plan.

Investment risk is not simply a score on a questionnaire or a line moving on a chart.
It is personal.

It depends on what you want your money to achieve, when you will need it and how much uncertainty you can realistically manage.

At Manning Gee Investments, we believe investments should support your financial plan rather than drive it.

A good financial plan can help you understand the risks you face, prepare for difficult periods and avoid making important decisions based only on fear.

Understanding risk is one thing. Living through a market fall can feel very different.

In our next guide, we will look at what happens when markets fall, why downturns are a normal part of investing and what history can teach long-term investors.

Frequently Asked Questions

Can I Invest Without Taking Any Risk?

No financial option is completely free from risk.

Investments can fall in value, while money held in cash may lose spending power because of inflation.

The important question is whether the risks you are taking are appropriate for your goals and circumstances.

Is a Cautious Investment Always Safer?

Not necessarily.

A cautious investment may experience smaller movements, but it could provide insufficient growth to meet a long-term objective.

Safety should therefore be considered in relation to what the money needs to achieve.

Does Investing for Longer Guarantee a Profit?

No.

A longer timeframe does not guarantee a return. However, it can provide more opportunity to recover from short-term market falls.

Your timeframe should always be considered alongside your objectives and capacity for loss.

What Is Capacity for Loss?

Capacity for loss is the extent to which you could withstand a fall in the value of your investments without it materially affecting your lifestyle or financial goals.

It is different from attitude to risk, which describes how comfortable you feel about investment uncertainty.

Should I Sell When Markets Begin to Fall?

A market fall alone is not normally a reason to abandon a suitable long-term financial plan.

However, investments should be reviewed when your circumstances, objectives, timeframe or need for the money change.

Investments can fall as well as rise, and you may get back less than you invested. Past performance is not a reliable guide to future returns.

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