Bank of Ireland
Investment Markets

Do you know your appetite for risk?

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When considering an investment for your money – what amount of risk should you take? It helps to understand your attitude to risk (sometimes also referred to as risk appetite or risk tolerance). Knowing your attitude to risk will help you choose the best home for your money.

TOP TIP

A financial adviser should always sit down with you to assess your risk appetite and financial circumstance before making any investment recommendations.

RISKS

Few people like to gamble with their hard earned money, but the truth is there's no such thing as a 'no-risk' investment. You have to take-on some risk when you invest, but the amount varies between different types of investment.

Money placed in deposits and savings accounts risk losing value in real terms (i.e. buying power) over the long term. This is because the interest rate earned on deposit won't always keep up with rising prices (inflation).

Stock market investments (shares or equities) usually beat inflation and interest rates over time, but you run the risk that share prices might be low at the time you need to sell. This could result in a poor return or, if prices are lower than when you bought, you could lose some money in the investment.

When you start investing, it's usually a good idea to spread your risk by putting your money into a fund that invests in a wide range of different asset classes (such as cash, shares, bonds, property etc.) that will likely perform differently depending on the investment environment. That way, if one asset doesn't work out as you hope, you've still got the others to fall back on. This process of spreading risk is known as 'diversification'.

WHAT IS RISK APPETITE?

Saving and investing involves a variety of risks, for example:

- The risk that an institution will fall (default risk),
- 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 risk),
- The risk that you could have earned better returns elsewhere (asset class risk).

What is a good balance for you will depend on:

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

Taken together these components make up what's called your 'risk appetite'.

It's important to recognize that your personal attitude to risk is hard to measure and can be changeable, as much depends on the changing external environment and your personal circumstances. Therefore it's important to 'take your temperature' by completing an attitude to risk questionnaire each time you consider investing, or are reviewing your existing investments.

Understanding your priorities, hopes and aspirations will shape your financial goals, and can help to quantify the amount required to meet the goal and the timeframe involved.

Your capacity for loss is influenced by your other financial commitments and the size of the proposed investment compared to your other assets and commitments.

HOW TO ASSESS YOUR RISK APPETITE

The following steps are a useful guide to help you 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 risk at all might make your goals impossible to achieve. Taking too much risk might make you too uncomfortable when the inevitable market jitters or falls occur – which may cause you to exit the investment at the wrong time.

Short-term goals, i.e. those that are likely to occur in less than five years – such as saving for a car or a deposit for a house are best saved for in cash. If you have a short-term goal, your appetite for risk would usually be low and regular savings products could be the best means to achieve it. You don't want to be worrying about the state of the financial markets when you need your money to be readily accessible. However, savings and deposit accounts run the risk of not keeping up with rising prices (inflation risk) over the longer term – particularly as interest rates are currently so low.

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 and property. These investments also carry the risk of prices going down, however, a longer time frame allows your investment more time to recover if it suffers occasional and temporary falls in value. So, if you have a long-term goal it makes sense to be prepared to take on some risk for the opportunity of earning higher returns.

As a long-term goal comes closer to being realised, the risk balance should change. For example, you might want to start moving into less volatile investments 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 might have a mixture of short-term or important goals for which you want to take low risk (such as saving for children's education), and some long term goals for which you have a higher appetite for risk (for example, saving towards retirement).

Step 3 – Understand your personal risk appetite

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

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, but when they are falling we get uncomfortable, emotion can take-over and investors are prone to making mistakes in this environment. Most people are not comfortable with the idea of losing money. The negative impact we feel of a loss is far greater than the pleasure we get out of making a gain.

On the other hand, you might regret it if you've been very cautious and as a result your long term investments don't produce the returns you need later on. Perhaps the biggest risk we take is actually the risk of not investing appropriately and saving enough to meet our long term goals.

So in summary, there are two key things to remember when you are considering savings or investing for your future goals. The first is your capacity for dealing with temporary loss (which will depend on your investment time-frame). The second is the nature of your investment goals (what you are saving for). Both of these factors will be the most useful in determining a good balance of risk for you.

Warning: The value of your investment can go down as well as up.
Warning: These funds may be affected by changes in currency exchange rates.
Warning: If you invest in these funds you may lose some or all of the money you invest.