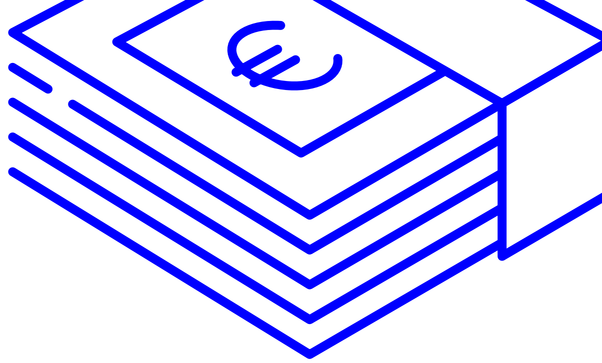
Begin

Investing: Is it a risky business?

Bank of Ireland



Investing: Is it a risky business?

When you think about investing do you focus on the potential for great returns —the possibility of buying a littleknown tech share that will increase in value many times over – or do you focus on the risk—the possibility of losing everything in a market crash or on a bad share pick

All investing involves some risk. But sensible investing is one of the best ways to increase the amount of money you have available to meet your financial and lifestyle goals.

There is typically a direct relationship between the amount of risk involved in an investment and the potential return you could earn from that investment.

Each of the different types of investments sit along this risk-reward spectrum. No matter what your goal is, you can find investments (or combinations of investments) that could help you reach your goal without taking on unnecessary risk.

The risk of different investment types - the main asset classes

The four main types of assets all have different levels of risk and potential reward. You can mix them in order to lower your chance of losing money.

- Of the four main asset classes, cash is the safest, followed by bonds, shares and then property.
- There are other, alternative, asset classes such as commodities, currencies (and cryptocurrencies), hedge funds, private equity etc. which have different risk and return characteristics.
- Safer investments have historically delivered lower average returns.
- By mixing investments (diversifying) you can get a balance of stability, income and growth potential.

ASSET CLASS	DESCRIPTION	MAIN ROLE	MAIN RISK	SOURCES OF RETURN
Cash	A savings or deposit account, paying interest. Can provide access on-demand, or limited access and a requirement to hold for a fixed term.	Security: Your capital is guaranteed. You won't lose money with these investments, but you won't gain much either.	The rate of interest paid on your deposit could be lower than the rate of inflation, or even be negative for certain amounts.	Returns come from the interest rate paid.
Bonds (also called fixed interest)	A loan issued by a government or company with a guarantee (or commitment) to pay interest and repay the principal (capital) at a specific time in the future.	Stability and Income: Getting a moderate return in exchange for a moderate amount of risk; getting a stream of income (coupon); offsetting the larger risk of share investments.	Because bond prices and interest rates move in opposite directions, rising interest rates could push bond prices down. The issuer of the bond could stop making promised payments or be unable to repay the principal at maturity.	Returns come from the coupon paid and possible capital growth (or loss) as the prices of bonds move.
Shares (also called equities or stocks)	By owning a share you have part-ownership of a company. There are a huge range of shares, industries, sectors and countries to select from.	Growth and Income: To participate in the profits and share price growth of companies. Some profits are paid to shareholders as dividends. In exchange for the potential of a higher return, there is a larger amount of risk. This risk can be reduced by investing across a wide range of shares.	Shares prices are influenced by multiple factors; this makes them volatile and means that share prices can drop for a variety of reasons, including poor company performance and concern about the economy.	Returns come from the possible dividends paid and possible capital growth (or loss) as the price of the shares move.
Property (also called Real Estate)	Commercial property – offices, retail, industrial, logistics, multi-tenanted residential.	Growth and Income: To participate in the rental income paid by tenants and possible future appreciation in the value of the property. Potential for a higher return as property is a relatively lumpy and illiquid asset. Reduce this risk by investing across a wide range of properties.	Property values are influenced by economic activity (particularly employment), the availability and cost of credit. The ability to buy and sell property can be impacted by factors – making it very illiquid at times.	Returns come from rental income and possible capital growth (or loss) as property values move.

Diversification – lower your risk by mixing investments

On average, shares have the highest potential return. Adding bonds tends to shrink the range of possible outcomes you could face every year—creating a lower opportunity for returns but also a reduced risk of loss.

If you have a long timeline (10 years or more) and a high risk tolerance, you might be fine just to invest in shares or property. But if you need your money in less than a year, or you have a low risk tolerance, you might need to keep a lot of your money in cash.

If you fall somewhere in the middle, your portfolio should be made up of a variety of asset types, giving you a more moderate level of portfolio risk.

Asset allocation: the key to matching your investment appetite

Asset allocation—the way you divide your money among asset classes is the first thing you should consider when getting ready to purchase investments, because it has the biggest effect on the way your investment will perform.

Extensive research[1] has shown that, if your investments are well diversified, almost 90% of your experience (the volatility you encounter and the returns you earn) can be traced back to your asset allocation[1]. In other words, your experience will be very consistent with that of any other diversified investor with the same asset allocation, no matter which specific investments they choose.

[1]Source: Determinants of Portfolio Performance, Brinson, Hood and Beebower, Financial Analysts Journal 1986

If you start building your portfolio by finding the right mix of asset types, you'll have more control over how risky your portfolio is. There are no "good" or "bad" allocations—you'll need to find the one that's right for you based on your own situation, return requirements and risk appetite.

Figuring out risk

Knowing how comfortable you are with the inevitable risks involved with investing is difficult if you have never thought about it or experienced it yourself.

Your risk tolerance is one of the critical ingredients in deciding what you're likely to be comfortable investing in. It will probably vary depending on your goal. If you have more time (or if your timeline isn't fixed), you have a greater ability to take risk. On the other hand, if you're starting your investment journey a little late, you have less room for unexpected events. In that case, you'd be better off taking a "safer" route.

Picking investments that are riskier than you can handle can lead to some unpleasant outcomes. But choosing investments that aren't risky enough- that don't have the right potential to generate the returns that you require - can also be a roadblock in reaching your chosen financial goals.

Your risk tolerance, time horizon, and ultimate goal all need to work together when you're deciding what to invest in.

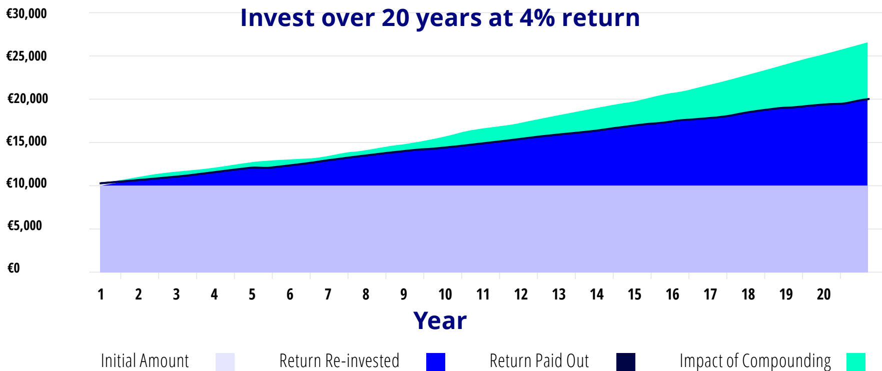
The importance of time – compound interest

Time can decrease your risk while increasing your reward. Allowing plenty of time to get to a destination is always a good strategy. When it comes to investing, the more time you have, the more you can benefit from compounding - the snowball effect that happens when you receive returns on your original capital plus accumulated returns. In this way your money can grow faster and faster as the years go by.

For example, if you invest €10,000 and earn 4% each year, you will earn €400 by the end of year 1. You start the second year with €10,400 after which your 4% returns delivers a gain of €416. At the end of the tenth year your annual gain has reached €569 and by the end of year 20 the annual gain is €843 and your investment has more than doubled to €21,911.

However, if you didn't re-invest the gain (i.e. no compounding) the annual gain would remain at €400 every year and the value of your investment would be €18,000 by the end of year 20.

Put another way, re-investing the annual return (to benefit from the compunding effect) means you generate a return of €11,911 on your initial investment over 20 years. Whereas by not re-investing the annual returns (and no compounding) you earn a return of €8,000 over the same period.



Source: Bank of Ireland

The longer you keep your money invested, the better your chance of overcoming the inevitable market wobbles. Based on past history, if you invested in the stock market for 1 year, your chance of losing money would be greater than 1 in 4. But if you invested for 10 years, that number would drop to about 1 in 25 and after 20 years the risk of suffering a loss falls to zero.

WARNING: Past performance is not a reliable guide to future performance.

WARNING: The value of your investment can go down as well as up.

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