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PERSONAL FINANCE

ARE YOU A RISK TAKER?

Do you enjoy mountaineering, abseiling, sky-diving, driving in Bali or similar? If so, you can reasonably be considered a risk taker. In which case there is also a good chance you take risks where investments are concerned. Is this a good thing or not? Read on…

The relationship between risk and return

The ideal investment would be one that pays a high rate of return but with no risk of losing capital and access to that capital at all times. Unfortunately no such investment exists. If it did there would be no need to invest in stocks, bonds, commodities, property or any other asset where money can be lost. The fact is that there is an inverse relationship between risk and return. If you are looking for an investment with a very high return then the risk of losing part or all of your money has to be accepted as a possibility. If you do not want to put your money at risk you should leave it in the bank and be satisfied with a minimal return.

But there are other dimensions to risk

While the risk / return relationship is a valid one it is not quite so simple. Time is another factor. For example, buying shares with the intention of selling them quickly could easily result in a loss. But if you are buying a share in a solid, 'blue chip' company with the intention of holding on to it the risk is actually quite low since the chances are it will appreciate over time and pay healthy dividends along the way. To be safer you should buy several stocks since even a solid blue chip company can 'hit the kerb', as in the case of BP, whose shares halved in value immediately after the disastrous blow-out in the Gulf of Mexico. Risk can also be reduced by diversification.

Another issue is liquidity. You may hold a solid asset but cannot turn it quickly into cash. This makes it risky since if you run out of cash you are insolvent!

So which assets are considered low or high risk?

Many factors come into play but as a general guide I would suggest the following:

***No risk*:** There is no asset in this category! Banks have been known to go under and even government guarantees are only as good as the finances of the respective government. Keeping money under the mattress is not the answer either!

Very low risk: Several deposits in more than one currency in government, large private or international banks. But keep in mind that holding cash for the long term is a risk in itself, since it will lose its purchasing power over time.

Low risk: Just one or two deposits as above.

Fairly low risk: Government bonds. Basically safe, since governments can always print money to meet their obligations. Capital values can however rise or fall during the life of a bond and there is also currency risk. This is why weaker currencies will generally offer higher returns. When investors are looking for a safe haven they will often buy US Treasury bonds even though they are currently paying less than 2% per annum over 10 years.

Low to medium risk: Corporate bonds as long as you invest in a range of companies since a single company could default.

Medium risk: Major market equities (shares) held for the long term. Investing in mutual funds in this category reduces risk through the variety of shares held. Land and property for the long term. Just remember you cannot sell a bathroom if you need cash in a hurry!

High risk: Emerging market equities, commodities, futures, private equity.

Very high risk: Complex investment vehicles such as derivatives. This is the where traders at JP Morgan Chase have just lost the bank $2 billion. The bank is big enough to withstand the shock but you and I don't belong in this area!

Variable risk: Some asset classes are less easy to classify. Hedge fund strategies for example can range from low risk to very high risk. Banks often issue 'structured products'. On the surface these are safe because the capital is guaranteed but your money can be locked in for up to five years and the guarantee is only as good as the bank that provides it. Thousands of investors were losers when Lehman Brothers went under. There are a number of very good asset classes such as student accommodation, forestry, litigation funding etc. They all have the potential to produce double digit returns but also share the risk of liquidity. You should not invest in these if you think you may need your capital returned in a hurry.

Conclusion

Anyone who cannot afford to lose even a part of their capital should not venture beyond the lowest levels of risk. But for those who have ample cash reserves and wish to build up their wealth a degree of risk-taking is essential.

There is no harm in taking risks so long as they are properly managed. This usually boils down to holding a blend of assets of various risk ratings, a high degree of diversification and a commitment to medium or long term investing. Sometimes there will be losses but, as they say, there is no gain without pain. And life without risk can be boring. Enjoy your next sky-dive!

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