

Investment Risk management

Risk

POLITICAL RISK

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- Relatively low in the UK these days (but Banking Sector?)
- Danger if investing in, say, Egypt (Centamin Egypt)
- Change of government creating new fiscal and monetary policies
- Quantitative Easing
- Change in taxation system
- Nationalisation or confiscation of assets (Russia)
- Corruption

Risk

OPERATIONAL RISK (INCLUDING FRAUD & COUNTERPARTY RISK)

Operational risk, fraud & counterparty risk are risks that can result in a fall in value resulting in an investor not meeting his/her risk and return objectives.

Operational risk looks at risks that arise from the investment process.

These include:

- Counterparty/Settlement Risk - the counterparty (often institutional), to a transaction may fail to settle – Lehmans. Early structured products particularly vulnerable.
- Fraud – internal or external – misappropriation of funds – Keydata - Madoff
- Misrepresentation – misleading reports & valuations (tend to come to light in a recession)
- System Failure
- Trading within institutions – trading errors and unauthorised trading - Nick Leeson at Barings, Kweku Adoboli at UBS
- Staff errors – fat finger syndrome
- Regulatory (FSA fine?)

Risk

***'ONLY WHEN THE TIDE GOES OUT DO YOU DISCOVER
WHO'S BEEN SWIMMING NAKED'***

WARREN BUFFET

Risk

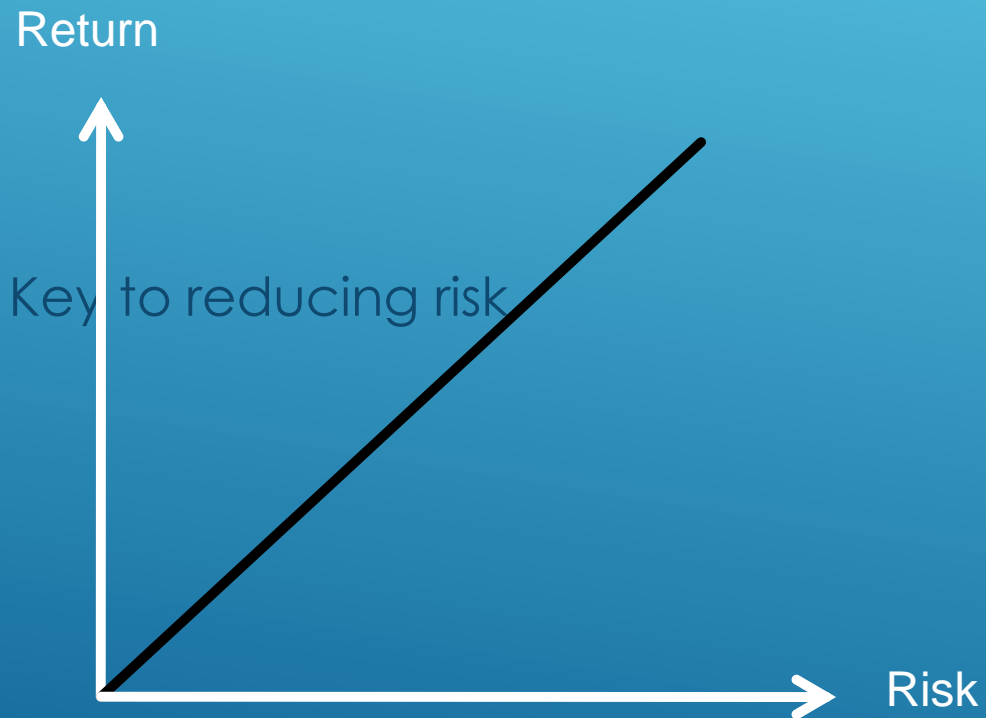
MARKET TIMING

Timing and timescales are very important but very hard to predict short term movements. Luck is a factor whether you like to admit it or not. Essential to ensure the client understands that, if a long term investor rather than a short term trader, they need to be able to 'ride out' any volatility if investing in these markets.

Earlier chart showing FTSE movement in first half of August this year is a perfect example of volatility – possible to make or lose 10% in a day during that period.

Risk

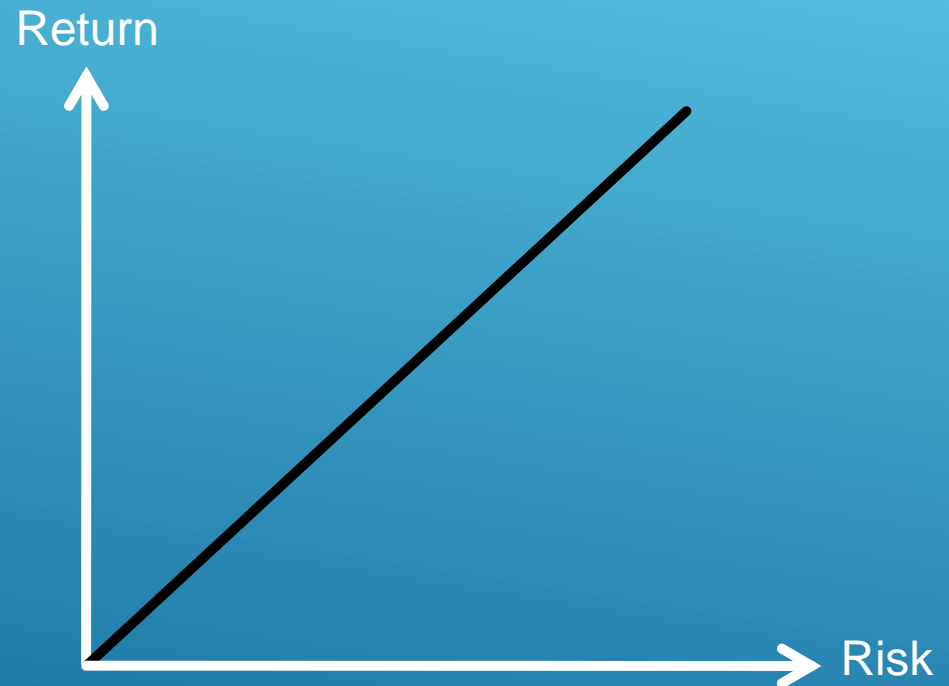
DIVERSIFICATION – RELATIVE RISK



DIVERSIFICATION – RELATIVE RISK

What would you expect to be the types of investments at the bottom of the line?

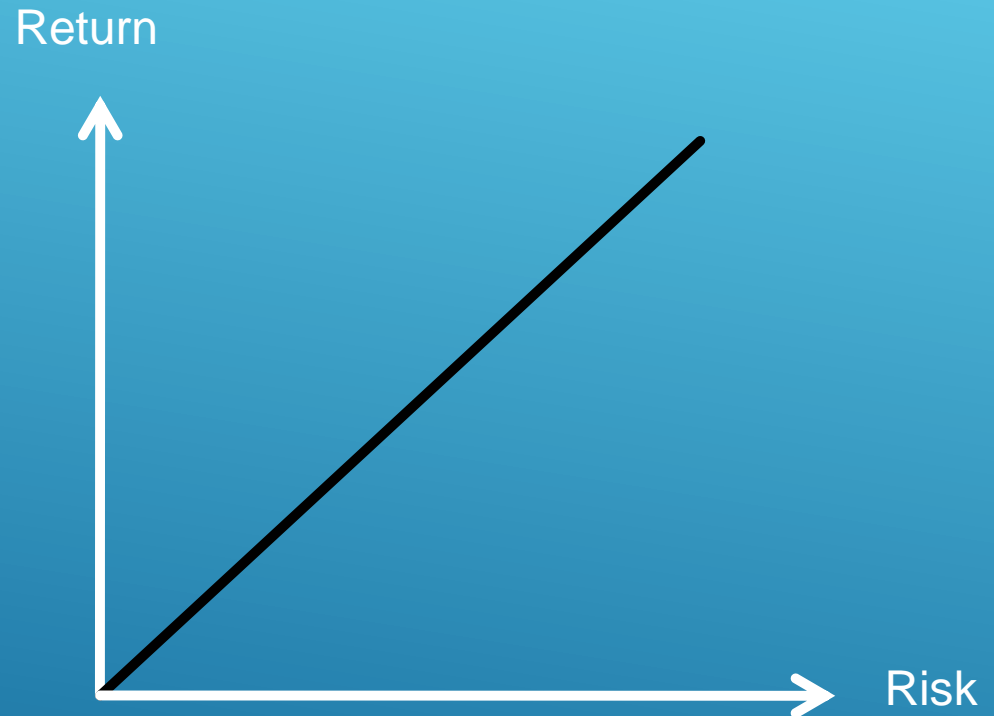
- Cash
- Bank/Building Societies
- National Savings
- UK Government Stock
- Life Assurance Policies
- FTSE 100 Loan stocks
- Some collective investments
- Structured products
- ETFs



Diversification – Relative Risk

And the investments at the top of the line?

- Listed shares
- Unlisted shares including AIM
- Property
- Loan stocks (ex FTSE 100)
- Gold
- Other commodities
- VCT/EIS
- Some collective investments
- Structured products
- ETFs



DIVERSIFICATION – RELATIVE RISK

‘Take calculated risks. That is quite different from being rash’

General George S. Patton (American General in World War 1 & 11)

Diversification – Relative Risk

DIVERSIFICATION CAN COME IN VARIOUS FORMS

- Different Asset classes can be held in portfolio – different betas to smooth out returns
- Equity investment spread over world markets. Individual stock markets do not always move in the same direction although correlation has increased in recent years.
- Use collective investments rather than individual companies although points 1 & 2 above still relevant.
- Spread equity investment across the UK market to avoid reliance on any one sector (i.e, Banks). Do you give the same weighting to Royal Dutch Shell as to Hargreaves Lansdown?

Diversification – Relative Risk

Top 5 FTSE companies by market cap

- HSBC Holdings £95bn
- Vodafone Group £86bn
- BP £84bn
- Royal Dutch Shell £79bn
- GlaxoSmith Kline £69bn

Bottom 5 FTSE companies by market cap

- Ashmore Group £2.3bn
- Hargreaves Lansdown £2.2bn
- Lonmin £2.1bn
- Inmarsat £2.0bn
- Investec £1.9bn