Michael
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Limited

# A client guide to
# Personal Risk Profile (PRP)
## investment markets and associated risks

Chartered
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# Introduction

This document should be read in conjunction with our documents entitled 'Costs and Services' and 'Explaining our Services' which set out:

- **How we work with you to manage your money**
- **The services and service level options that we offer**
- **The charges we make to pay for these services**
- **Other charges that you may experience when using our service**

This document will outline how we define and measure risk and how we categorise the risks associated with various asset classes. If you require further information, please don't hesitate to contact us and in any event a discussion with your adviser on this topic is essential.

# Understanding and measuring risk

## How do we define risk?

Risk is a personal issue and our role as independent advisers is to help you to understand risk in the investment market and assess your capacity to deal with that risk. There are two main elements of risk to be taken into account when making investment decisions.

- Your Personal Risk Profile (PRP)
- Risks associated with your investment choices

## Your Personal Risk Profile

We will assess your capacity via an in depth discussion which is then matched against one of our risk profile definitions.

As part of this process we will also seek to discuss and eventually define the amount of risk required to achieve your personal financial objectives. This aspect is known as the risk requirement.

Once we have gathered sufficient information, we create your tailored Personal Risk Profile (PRP).

## How do we define capacity?

We believe that capacity, in the context of risk, has three key elements;

1 **Physical capacity.** This is the amount of money that you are considering investing, as well as the timeframe over which you wish to invest. Our role is to help you establish accurately the amount of money you have to invest, the amount of money you need in the future and your ability to absorb losses should any arise.

2 **Mental capacity.** This refers to the knowledge you have of investment products and your experience of dealing with the investment market. Our role is to give you sufficient information, in a format appropriate for you, to enable you to make informed decisions.

3 **Emotional capacity.** This is the way that you feel about your invested monies and the reactions you may have to gains and losses within your investment portfolio. Our role is to give you understandable examples of the types of assets your money can buy and the potential upsides and downsides of each one.

## Risk associated with your investment choices

Whilst each type of asset class has the possibility of creating a gain, it also has the possibility of creating a loss and our role as independent advisers is to ensure that your decisions take this into account. This has to be done before you make any decisions about your investment strategy.

Associated risks are changes to the risk environment or market which may influence your investment decisions. These could include a change of job or market events such as the banking crisis of 2008 which may alter your capacity for risk. Due to the importance of investment decisions, we recommend regular reviews with your adviser.

**We have identified 3 areas of change to the risk environment that we believe may materially alter your Personal Risk Profile (PRP.)**

These are:

1 **Personal circumstances.** Such changes could include career moves, alterations to your marital status, the arrival of children, changes to your medical status or those of your partner or spouse, or substantial changes to your financial situation. Whilst we will always ask you about these changes during our annual review, please let us know should any changes occur between reviews, as they may affect your overall PRP.

2 **Market corrections.** Most investments taken out should be viewed as a medium to long term arrangement, typically from 5-25 years in length. The investment markets move in cycles and as such we would not normally expect short term market movements to impact your PRP. However, in exceptional circumstances such as the banking crisis in 2008-2009 this may impact upon your capacity for risk as outlined above.

3 **Fund manager or investment house changes.** When we make our recommendations regarding fund manager choices we do this based on what we know about the fund manager at that time. However, if the manager is changed, or the mandate for a fund is changed or there is a significant alteration to the potential performance of the fund in the future, this can impact upon the risk strategy adopted for your portfolio.

# Asset classes and their associated risks

We have identified 6 main risk profiles that have proved suitable for the vast majority of our clients and are used by us as a guide to the types of investments we suggest. These are explained in our document 'Your Personal Risk Profile' (PRP), however before we can assign a risk to an individual, we need to consider asset classes.

Money markets and investments of any variety carry an element of risk, either due to short term volatility or due to long term erosion of value. This section on asset classes seeks to give you a good understanding of the types of risks associated with each type of asset.

## Types of asset classes

An asset class is a term used to identify different categories of investments. The list below covers the main asset classes in use and the risks associated with them. Your portfolio may contain some or all of these asset classes, but your adviser will be able to offer more specific information on these and how this is reflected in your overall risk profile.

### 1. Cash deposits

There are many types of deposit accounts run by institutions such as banks, building societies and National Savings and Investments.

**Return** – Generally provide interest but no capital growth

**Risk level** – Low level but not risk free

**Investment type** – Used to cater for unexpected, short term spending needs or to act as a short term home for money when other asset classes are showing unusual levels of volatility.

The potential risks are:

- **Absolute risk.** Although very rare, not all banks are covered by the Financial Services Compensation Scheme (FSCS.) In 2008, two Icelandic banks trading in the UK (Icesave and Kaupthing Singer Friedlander) collapsed. However, most banks in the UK are covered up to a maximum value of £85,000 per person per institution. Similar schemes exist outside of the UK, such as the one in Ireland covering the Bank Of Ireland for example.

- **Capital value risk.** After allowing for inflation, the real spending power of cash deposits may erode over time. As an example, with inflation at 3.5% per annum over 5 years, the spending power of £100,000 would fall to £83,700 in real terms.

## 2. Fixed interest stock

These are effectively certificates issued in return for loans made to either companies or the government. In the former case they are called corporate bonds and in the latter case gilts.

**Return** – Generally they do not provide capital growth as they are designed to provide interest, known as the coupon. If the coupon is re-invested this may provide a form of capital growth.

**Risk level** – This asset class is generally thought to be at the lower end of the risk spectrum with a possibility of outperforming cash deposits in the medium term. However, some risks do exist as explained below.

**Investment type** – Usually, but not always, for a fixed term with a fixed rate of interest and with the capital to be repaid at the end of the term.

It should be noted that the capital value can rise and fall with changes in the economic or political landscape. Generally, we recommend that our clients invest in these instruments through a collective fund such as a unit trust or open ended investment company. It should be noted that companies and indeed governments borrowing money this way are given a credit rating by an agency. These range from AAA where the institution is thought to be very financially secure and unlikely to default on the loan to lower ratings such as C where the risk is much higher. Please note that these ratings are not fool proof. Just before its collapse Lehman Brothers was rated as an A.

The potential risks are:

- **Absolute risk.** The borrower defaults on the loan.

- **Capital value risk.** If cash interest rates rise it is likely that this will depress the capital value of the fixed interest stock.

## 3. Commercial property

Like many other asset classes, property is cyclical and there will be periods, possibly prolonged where capital values fall or stagnate.

**Return** – Over the long term, this asset class does have the potential for both capital growth and rising income.

**Risk level** – We believe that commercial property is a medium risk asset and can play an important part in a diversified portfolio. Generally commercial property is not linked to either equities nor to fixed interest markets so a fall in them does not necessarily equate to a fall in this asset class. 2008 was an exception to this as all asset classes were challenged.

**Investment type** – As a medium to longer term investment, we generally recommend that our clients seek exposure to this asset class through a collective fund rather than a specific investment in actual bricks and mortar. We recognise however, that for some clients, perhaps with a SIPP or a SSAS pension, a direct investment may be appropriate.

The potential risks are:

- **Time delay.** It takes a reasonable length of time to buy and sell a direct property investment and when markets start to fall, even a fund may close to withdrawals for a period as it cannot necessarily sell a property to give back the cash to investors.
- **Absolute risk.** The capital values of properties will fall from time to time, sometimes significantly. The largest falls seen in this sector resulted in a 43% reduction in capital values between late 2007 and April 2009 (source Investment Property Databank Index). Prices subsequently rallied, but even when income was taken income account it took investors until the start of 2014 to recoup an initial investment made in 2007.

## 4. Equities

This refers to shares in a company, for which the value may fluctuate.

**Return** – In the short term they can exhibit extreme volatility often driven by nothing more than sentiment, but over the medium to long term this asset class his historically outperformed the other main asset classes. Over the 30 years from 1 January 1988 to 31 December 2017 (assuming all interest and dividends are reinvested) UK equity returns have given an inflation adjusted profit of £415,310 with an initial investment of £100,000. This compares to a figure of £55,870 for a deposit account which has tracked the Bank of England base rate.

**Risk level** – They have to be seen as a risky asset class and in particular subject to sudden rapid falls in value in the short term as they move up and down subject to the laws of supply and demand.

**Investment type** – Equities are suitable for the medium to long term investor as they have exhibited a profound ability to create value over the medium to long term.

The potential risks are:

- **Volatility risk.** Equities as an asset class can certainly lose value, particularly in the short term during their period of ownership and this loss can be sudden and unexpected. We would recommend investment via some form of fund to obtain suitable diversification and potentially in a fund of funds as the equity market spans the entire globe and specialist knowledge is needed to extract the best value from this asset class.
- **Absolute risk.** Certain individual equities may lose some or all of their value on a permanent basis, as in the case of Marconi.

## 5. Relative Investment returns

Generally we like to explore all of the main asset classes as they can all perform a different function within a portfolio. The key is to blend them together in the correct proportions and this will form a large part of the conversation with your investment adviser. We also make use of other investments that may not be comprised of these asset types, such as National Savings products, structured products and targeted absolute return funds. Your adviser will be happy to explain and discuss this with you.

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# Contact us

## Michael Ambrose Limited
### Independent Financial Advisers

This document is intended as a brief summary to help your understanding but it is important to remember that it is our relationship that will ensure that the investment choices we make on your behalf are appropriate to your needs. There is no one model that works for everyone and we will spend a lot of time making sure that your portfolio is bespoke and right for you.

We'll be really happy to help with any queries which you may have. Just get in touch.

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