Risk matters: an introductory guide

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At the heart of investing is a simple concept that goes a long way in helping to understand what it's all about: the risk-return trade-off.

What is the risk-return trade-off?

There's no such thing as a risk-free investment. When you invest you take the risk that the value of the investments you buy goes down as well as up, meaning you might get back less than you put in. But in exchange for that risk you're getting the potential to make a profit over time.

The risk-return trade-off is this: the higher the level of risk you take the higher the potential returns, if things go your way, and the higher the potential losses if they don't. Conversely, the lower the level of risk you take, the lower the potential for both returns and losses.

Understanding your risk profile

Finding the right risk-return trade-off for you starts with understanding your personal risk profile. There are two main elements to this. The first is to have a good idea of how much risk you're able to take in pursuit of your investment goals without putting your finances in jeopardy. This is known as your capacity for loss. The second is to be clear on how much risk you're willing to take. This is known as your tolerance for risk.

If the level of risk associated with a particular investment is likely to keep you awake at night, it may be too risky for you – that is, beyond your tolerance for risk. Yet there's also a risk in being too cautious - the risk-return trade-off means that if you need a certain

amount of growth to meet your goals, you may need to take a certain amount of risk too. If that level of risk feels uncomfortably high, then you may need to review your goals.

There is a whole science around building personal risk profiles. So if you seek support from a financial adviser or online investment service, they will often use a questionnaire that has been developed by specialists to help you understand your own profile.

Building a portfolio to match

Once you have that understanding you can put together a portfolio of investments with a risk-return trade-off that's suitable for you. There are a number of different routes for doing this from building your own portfolio of individual investments to using a multi-asset fund or model portfolio service. Again, a financial adviser can talk you through the options if you are not sure how to approach doing this yourself.

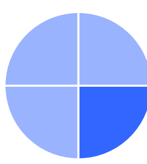
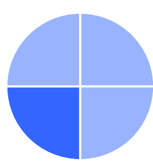
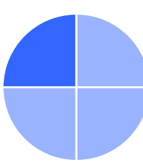
To be able to put together a suitable portfolio you need an understanding of the particular risks associated with different types of investment. Shares, bonds, property and cash are some of the most popular asset classes and tend to form the building blocks for most diversified portfolios.

It is possible to invest in all of these directly, but for shares, bonds and property, individual investors often choose to do so through collective investment funds, run by investment professionals like Santander Asset Management.

Learn more

Read **'Navigating your investment routes'** for more on the different ways you can go about building a portfolio of investments.

A quick overview of the main risks

Investment type		The main risks
Shares	The value of a company is broken down into pieces called shares (also known as equities), which you can then buy. Shares can pay you an income (a dividend) although this is not guaranteed.	The value of your investment goes up and down in line with the fortunes of the company. The same goes for any dividend payments, which can also vary and may not be paid at all. There's also a risk of losing money if a company which you invest in goes bust. Companies come with different levels of risk, depending on the type of business they are in, how well established they are and how easy it is likely to be to buy or sell their shares when you need to (how 'liquid' they are).
Bonds 	These are a type of loan to a government or company over a fixed period which usually pays out a fixed amount of interest.	Bonds can be vulnerable to interest rate risk (where the fixed income you get doesn't keep pace with rising interest rates). There's also a risk of the issuer defaulting on its payments (credit risk) if it can't meet its financial obligations. Bonds are usually rated by independent rating agencies to help you assess their level of credit risk. This risk is typically seen as lower for government bonds (known as 'gilts' in the UK) and corporate bonds issued by the most financially sound and stable companies, than it is for other types of bond.
Property 	You put your money in companies which invest in physical buildings or own hotels, offices, retail shopping centres etc.	Both the value of property and rental income from it can fall as well as rise. The valuation of property can be more a matter of judgement than fact, and if there is high demand to take money out of a property investment it may be difficult to access your money at short notice, or when you need it, mainly because property takes time to sell (it is illiquid).
Cash 	Your money is held on deposit in bank and building society accounts.	Cash doesn't go down and up in value, but it isn't without risk. The interest you receive may not keep up with rising prices (inflation) meaning the buying power of your cash reduces over time.

Your time-horizon matters

Shares usually have a big role to play for any investor seeking some degree of growth. But the exact proportion that's right for your risk profile is where the risk-return trade-off comes in.

How long you're investing for (your time-horizon) is an important consideration here. For example, if you're investing for a retirement that's still more than 10 years away, you may feel comfortable taking more risk with a higher proportion of shares because history shows that shares will typically grow over the long-term and smooth out any bumps along the way. The shorter your time-horizon, the less opportunity there is for that smoothing effect to occur.

Doing research matters too

If you choose to invest through one or more collective investment funds, it's not enough to understand which asset class(es) these are invested in. Within each asset class some investments involve taking far more risk than others. It's the combined impact of all the risks involved across all the investments made by a fund that influences its overall risk-level.

Some types of fund are managed to stay within a target risk-level. This is a common approach with multi-asset funds for example, which typically invest in all of the main asset-classes under a single fund roof. Other funds have more general aims: for example, UK shares look to beat the performance of the FTSE All-Share Index. In practise, the level of risk they take may change over time depending on market conditions and the risks involved with each of the individual investments chosen by the fund manager.

Investment funds have to offer either a Key Investor Information Document (KIID) or a Key Information Document (KID), both of which provide standardised information. That includes the aims of a fund and its risk and reward profile (effectively, it's risk-return trade off), on a standardised scale of 1 to 7. Level 1 is at the lowest risk end of the risk-return trade off and 7 at the highest. It's always essential you read a fund's KIID or KID before investing to make sure you understand what you are buying into.

Getting the balance right

Trade-offs are ultimately about compromise. So you may need to make some compromises along the way as you find the right balance for your portfolio, such as a tweak to your goals or a willingness to take a bit of extra risk.

It will always be the case that investments can go down as well as up and you may get back less than you put in, but if you can get your risk profile right and identify the most suitable funds to match, you're on the way to meeting your goals without too much stress. If you are not comfortable doing this yourself, this is one area where working with a professional financial adviser may turn out to be one of the best investments you make.

Let's be clear!

Investment terms explained

Asset class: A group of investments with similar traits. Shares, bonds, property, cash and alternatives are all examples of asset classes.

Bonds: A bond is a loan issued by a government or a company. When you buy a bond, the issuer promises to pay a certain amount of income until the bond redeems and is repaid by the issuer. The strength of that promise varies by the issuer of the bond. This is known as creditworthiness.

Diversification: Spreading your money across different investments to help manage risk.

Dividend: The income you can earn from equities.

Fixed Income: Also known as Fixed Interest. A group of asset classes that involve debt, this is usually in the form of bonds where an issuer will lend money for a predefined period and these can be issued by governments or companies. These will involve a regular coupon (interest) payment and the return of capital (original amount lent) at the maturity of the bond.

Index: A way of tracking the overall performance of a basket of individual investments of a similar type. For example, the FTSE 100 index tracks the performance of shares in the 100 largest companies by market value on the London Stock Exchange.

Inflation: Measures the increase in price of selected goods and services in an economy over a period of time.

Portfolio: a group of investments that are managed together to meet a particular objective.

Property: Property may be difficult to sell and can demonstrate significant declines in value due to changes in economic conditions and interest rates.

Shares (often referred to as Equities or Stocks): In investing, this is a share of ownership in a company. Investing in a fund gives exposure to underlying share prices without investors actually owning the shares themselves.

Time horizon: How long you expect to be investing for before you might need your capital back. Investing should usually be for a minimum of five years or more.

Important Information

This material is for information only and does not constitute an offer or solicitation to buy or sell any securities or other financial instruments, or to provide investment advice or services.

Past performance is not a guide to future performance. The value of investments and any income is not guaranteed and can go down as well as up and may be affected by exchange rate fluctuations. This means that an investor may not get back the amount invested.

Subscriptions to a portfolio may only be made on the basis of the current Prospectus and the Key Investor Information Document (KIID), as well as the latest annual or interim reports, which can be obtained free of charge on request, and the applicable terms & conditions. Please refer to the 'Risk Factors' section of the Prospectus for all risks applicable to investing in any portfolio and specifically this portfolio.

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