ZURICH

Understanding your investment risks

What are the risks of investing?

There are many risks associated with investing. The information below provides details of the main types of investment risk you could be exposed to.

We are responsible for giving you access to clear information about the types of investment available to you and the risks you should consider. You are responsible for making sure that you are satisfied you understand the assets you are considering investing in, including the associated risks, so you can make an investment decision.

Risk factors

Whatever you invest in, you could lose some or all of your money – nothing is guaranteed. You should understand the risk of each asset you're considering investing in before you invest in it.

Although the investment risk associated with cash is low, its value may be at risk of being eroded by inflation. In some circumstances, when interest rates are low, the returns on cash may be less than the charges.

Investment funds, shares and gilts share many risks – however, the level of risk will vary considerably between different funds and different shares and gilts. Some shares and gilts can be high risk and you should make sure that you understand all the risks involved before you invest.

The risks associated with investment funds will depend on the assets in which they invest.

The following generic risks are in alphabetical order.

Charges taken from capital
Fund manager charges vary widely between fund managers and the funds they operate. Some fund managers will take their charges directly from the fund's capital rather than from the investment income its underlying assets generate. This results in higher income but lower capital growth and there is a risk of capital erosion.

Concentrated asset portfolio
This will include funds that specialise in a specific market. For example, this might be a particular sector such as technology, or a geographical region such as the Far East. It may also include those funds that limit their investment portfolio to a particular asset class. Such funds are likely to carry more risk than funds that spread their investments across a wider range of assets and asset classes.

Credit/Debt
The returns on debt securities for example certain types of money market instruments such as commercial paper as well as company bonds and government bonds, all depend on the continuing ability of the issuing company or government to service the interest payments and repay the loan at maturity. The level of credit risk depends on the likelihood of the company or government that issued the bond defaulting on its financial obligations. The credit risk of individual companies and governments is measured by agencies such as Standard & Poor's, Moody's and Fitch.

Dilution levy/adjustment
When fund managers buy and sell assets in a fund, associated dealing costs (such as stockbroker fees and taxes) are normally taken from the fund. These costs are reflected in the share price and the performance of the fund, so they are shared equally among investors.

However, if investors (individually or collectively) are buying or selling significant numbers of shares, relative to the size of the fund, the resulting dealing costs may adversely affect existing investors. This is called 'dilution'. The fund manager may offset the effects of dilution so that investors who are not buying or selling at these times are treated fairly.

A fund manager may do this by either:

- applying a dilution levy, deducted from the value of transactions made by investors who are buying or selling at these times. The levy is paid into the fund and is used to cover the associated dealing costs, or
- making a 'dilution adjustment' by adjusting the share price to take account of the dealing costs, so that only those investors buying and selling on that day are affected.

Emerging markets
Assets that invest in less developed markets are at higher risk from political and economic instability that may lead to increased price and currency volatility.

Equity
The value of shares and the risks associated with them depend on many factors. As well as the underlying performance of the individual company, share prices will be affected by market expectations of risks and opportunities relating to the market sector, particular industry, the wider economy as well as any other outside factor that might influence a company's performance. For example unexpected events such as natural disasters.

Exchange rate
This risk results from the changes in the relative price of one currency against another. It affects assets that are valued in, or have a value derived from assets priced in a currency other than pounds sterling. For example, funds may be denominated in sterling but invest in assets denominated in US dollar. The rate of exchange between sterling and every other currency is constantly changing and the level of exchange rate risk is determined by the speed and extent of those changes. Typically, if an asset has a stable price in US dollar but the value of sterling increases relative to the US dollar, it will cause the relative sterling denominated value to fall.

High-yield bonds

Companies and governments issue bonds to raise money, the interest rate they have to pay will depend on their credit rating, the lower their credit rating the higher the interest rate or 'yield'. As such, funds that invest in high-yield bonds are exposed to more credit risk and are at greater risk of financial loss from the issuer of the bond defaulting on its financial commitments.

Inflation

This generally applies to assets and funds that invest in such assets that provide steady but low levels of growth or income and reflects the probability that the value of the asset or income will be reduced as inflation shrinks its relative value. The higher the level of inflation, the quicker the relative value (or put another way, the purchasing power) of the asset, or income produced by the asset, will reduce.

Interest rate

This affects money market instruments and fixed-rate assets such as bonds where the trading value is affected by changes to interest rates. Typically, the trading value of a bond will fall when interest rates rise and rise when interest rates fall.

Liquidity

This risk is when it may not be possible to buy or sell an asset at the time, or in the quantities needed. This risk arises when market conditions prevent the buying or selling of that asset. This is particularly relevant to property-based assets. In addition, it will not be possible to buy or sell if trading has been suspended. This may be due to excessive market volatility, which may automatically trigger a suspension in trading or an event specific to the fund or share.

Trading in assets in less developed markets can also be subject to liquidity restrictions.

Political

Financial markets run in a regulated environment. Governments or regulators can change the rules which then affect the value of assets based in those countries, particularly in less developed countries. Examples of this are the application of economic sanctions if a government nationalises a company or industry.

Property

Property funds are normally valued by taking account of the views of an independent valuer, property market conditions and the value of recent property sales. At times the value of such funds can fall sharply and the costs for buying and selling can rise sharply. In addition, there may be restrictions on selling holdings in such funds (whether they hold property directly or property company shares), particularly if property needs to be sold first. This may prevent the sale of assets for up to a year, or possibly longer. Property funds may invest directly in residential, commercial and international property or indirectly through investments in property companies that own and manage property on a commercial basis.

Small companies

Funds that primarily invest in small companies, may experience greater levels of price volatility than those of larger, more established companies or the funds that invest in them.

Stabilisation

During and after a public share issue, the price of the shares may be artificially maintained to prevent the price dropping before buyers can be found. Stabilisation rules allow the price to be fixed for a limited period and require the disclosure that the price may be stabilised. The effect of this may be the price at first is higher than it would have been.

Volatility

The measure of how much an asset price changes over a given period of time. More volatile assets will have larger changes in price over shorter periods of time. This risk is associated with certain types of individual assets, particularly shares, which are fairly volatile. This is because their price and the dividend payments they produce can be sensitive to external risk factors, for example natural disasters, as well as the underlying performance of the company itself. The risks associated with volatility can be reduced by holding a range of assets with a view to long term investment (over 10 years) enabling you to ride out periods of volatility and to give flexibility about when to sell. Excessive volatility, in particular when markets experience sharp falls in value in a short time, may automatically trigger a suspension in trading.

Correlation and diversification

Asset correlation is a measure of how investments move in relation to one another. When assets move in the same direction at the same time, they are highly correlated. When one asset tends to move up when the another goes down, the two assets are non-correlated.

Correlation ranges between a scale of -1 and +1. Perfect positive correlation based on a measure of +1 means that as one security moves up or down, the other security will move in the same direction. Perfect negative correlation of -1 means that when one security moves in one direction, the other security will move by an equal amount in the opposite direction. If the correlation is 0, the movements of the securities are said to have no correlation; they are completely random.

This is where diversification comes in. Just as a balanced diet is good for your health, holding a balanced, diversified portfolio can be good for your investments. Diversifying your portfolio with a mix of non-correlated assets can help protect it from the ups and downs of the market. Let's use an example of investing in two companies, one which sells sun cream and the other sunglasses. These are highly correlated as poor weather would result in low sales of both. However investing in companies selling sun cream and umbrellas would provide perfect negative correlation as when one is performing well, the other isn't, and vice versa when the weather changes.

Even well-diversified portfolios are at risk from market movements. All investments can fall as well as rise. But a portfolio that's diversified will generally move less and produce more balanced returns – both gains and losses. This might involve investing across some or all of the main asset classes of money market instruments, bonds and gilts, shares and property.

We’re here to help

Please click on the link below to contact the
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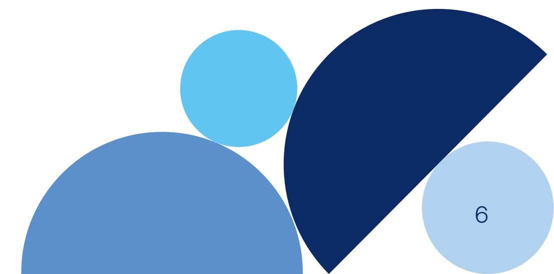

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