

# The Trustee toolkit downloadable

## An introduction to investment

### Tutorial six: Risk and reward

By the end of this tutorial you will better understand:

- ▶ the balance between risk and reward
- ▶ how the common asset classes compare

This tutorial is part of **Scenario three**.

#### Glossary

A detailed glossary of technical terms can be downloaded from the Resources tab when you log in at [www.trusteetoolkit.com](http://www.trusteetoolkit.com)

## Balancing risk and reward

Every time you invest some money you hope to be rewarded by the investment growing and/or by receiving an income from that investment.

A general rule of investment is that the more risk you take, the higher the potential reward but also the greater the potential for getting back less than you originally invested (making a loss).

The reward for investing is often described as the return on the investment. The return on an investment is the amount by which the investor has benefited from owning that asset. When you invest money you usually expect to get a return.

## What makes up 'reward' or 'return'?

Return has two elements: income and growth in value. It is possible to have a negative return from an asset if its value drops below what you paid for it.

### Equities

If you buy equities (shares), the income will be in the form of dividends (a share of the profits) and growth will be in the form of an increase in share price.

### Bonds

If you lend money (eg buy a bond) then the income will be in the form of interest and there is unlikely to be any capital growth.

### Property

If you invest in property then the income will be in the form of rent and the growth will be in the form of an increase in value of the property.

### Pooled fund

Where you are invested in a pooled fund then the income and growth in value will be reflected in the price of the units.

## What is the difference between gross and net returns?

Gross return – costs = Net return

The investment return before costs have been taken into account is referred to as the gross investment return (or the gross return).

The investment return after costs have been taken into account is referred to as the net investment return (or the net return).

Some investments require more management and this adds to the cost.

The cost of managing the investment should be considered when assessing the level of return as the 'net return' is often considered to be more important when assessing performance. This is what the investor can expect to receive.



### Other types of return

Take a look at the descriptions below. Have a go at matching them to the correct type of return. It doesn't matter if you get this wrong, thinking it through is more important and you will get feedback.

Possible answers: Absolute return, real return, relative return

1. The return is measured after taking account of inflation
2. The return is measured without reference to any other investment, benchmark or index
3. The return is measured with reference to another investment, benchmark or index

[Answers are at the back](#)

## Examples of assets designed to give a real return

Index linked gilts, for example, are designed to offer a real return by promising a specific return above inflation – both in respect of the interest payments and capital repayment.

So, a real interest rate of 2% means 2% above the rate of inflation. In addition, when the loan is eventually repaid, the loan amount will have been revalued to take account of inflation.

Equities can be considered as representing an investment in the economy. The value of equity investments might be expected to increase by more than enough to be in line with ‘real’ economic growth over the long term. However, this cannot be guaranteed.

## Risk

The amount of risk that an investor is prepared to take may depend on a number of factors, including:

- ▶ their reasons for investing
- ▶ the amount required at the end of the investment
- ▶ the length of time they are investing
- ▶ whether they might need to access the funds more quickly
- ▶ their overall wealth position relative to the amount being invested

For example, someone saving for a deposit with the aim of buying a house in two years’ time may wish to consider a lower-risk investment because they need a specific amount and cannot afford to lose what they already have. If there is a possibility that they might want to purchase a property at an earlier point of time then they might also want to ensure that they had relatively quick access to the money.

Alternatively, someone who is saving to pay off a mortgage in 25 years’ time may be prepared to accept more risk because they are investing for a longer period and they need a large amount of growth to clear the debt. However as the day to repay the mortgage gets closer, they may wish to protect the growth they have achieved so far by switching into lower risk investments.

## Risk and reward of the main asset types

### Equities

Equities are traditionally the most volatile of the major asset classes. This means they carry a higher risk than the others, but may also offer a higher return. Listed equities are usually liquid assets, ie they can normally be bought and sold quickly and easily.

### Bonds

Bonds are also normally viewed as liquid assets. As an asset class, they are less volatile than equities. They generally carry a lower risk and offer lower returns.

Government bonds generally offer a lower return than corporate bonds, but historically that income has been viewed as more secure. However, there have been notable exceptions to this principle. This has been seen during the economic crisis in the Eurozone countries (from 2009) in the behaviour of bond markets in Greece, Italy, Spain, and at other times in Russia and Latin America.

Corporate bonds are only as secure as the company that issues them and recovery of investments in the event of a failure will depend on the value of the assets that the company has put up as security for the borrowing and the costs of realising those assets.

### Property

Property tends to be less liquid than equities. Illiquidity creates greater risk and the returns should reflect that risk. Although property itself is a relatively illiquid asset, property funds may allow their units to be bought and sold more quickly and easily than individual properties. However, in periods of economic stress there have been occasions when it has not been possible to trade some property funds because of the illiquid nature of their underlying assets.

### Cash

Cash is usually considered to be the most liquid asset. Deposits are often held in bank accounts and do not change in value. Because they do not have much risk they offer low returns.

Cash funds are different from cash deposits. They can be invested in a wider range of financial products that are likely to carry greater risks and can have different characteristics from cash deposits. Funds that offer higher rates of return than expected are likely to carry greater risks. The characteristics of the specific 'cash fund' therefore needs to be understood before an investment decision is taken.

If the return achieved from a cash deposit or a cash fund is less than the rate of inflation then the real return is negative. Trustees should therefore be conscious of the risk that the real value of the investment is falling.

## The risk and reward balance

This tutorial has so far described the factors that affect the amount of risk that an investor is prepared to take, and the risk and reward associated with four of the most commonly used asset classes.

The remainder will briefly summarise how scheme investments for both DB and DC arrangements need to establish a balance between risk and reward. This follows what we have learned in previous tutorials, that trustees should select investments that enable them to meet their scheme's investment strategy.

## Risk and reward in DB and DC schemes

As we saw in the Tutorial: 'Investment in a pension scheme', both DB and DC trustees must make the investment decisions with appropriate advice from professional investment advisers.

### DB schemes

DB scheme trustees have the task of selecting, monitoring and reviewing a mix of assets which provides an appropriate degree of risk exposure and potential for reward for the scheme investments.

DB schemes need to balance the risk and reward so that they achieve adequate returns to pay the pension benefits of the scheme members whilst taking account of the strength of the covenant of the employer(s) supporting the scheme.

They also have to ensure that assets are sufficiently liquid, in order to be able to release funds from the scheme investments and pay the benefits as they become due, whether on a long term or a short term basis.

You will find more information in the Module: 'Investment in a DB scheme'.

### DC schemes

DC trustees have the task of designing, monitoring and reviewing a default strategy and for ensuring the long term suitability of the investment funds underlying the default strategy. DC trustees must also make alternative funds available to members who choose their own investment strategy.

As the investment risk for DC schemes is held by the members, it is important that the level of risk is appropriate and that the information available on the funds accurately describes the degree of risk.

However, it is, for example, also important that members are made aware that excessive risk-aversion, evidenced perhaps by long term investment in cash, carries a risk of accumulating an insufficient fund to produce an adequate pension.

You will find more information in the Module: 'Investment in a DC scheme'.

# Answers and feedback

## Other types of return

Absolute return is the return when measured without reference to any other investment, benchmark or index.

Relative return is the return on an investment when measured with reference to the return generated by another investment, benchmark or index. For example, if a fund investment generates a return of 2% while its benchmark index generates a return of 5% then the relative return of that fund is -3% while the absolute return is 2%.

Real return is a measure of return after taking account of inflation. For example, if a fund investment generates a return of 6% while inflation is running at 5%, the real return of the fund is 1%.