**R02 Unit 1: Main Risks**

[**https://quizlet.com/gb/867817022/unit-1-main-risks-flash-cards/?i=24ef59&x=1qqt**](https://quizlet.com/gb/867817022/unit-1-main-risks-flash-cards/?i=24ef59&x=1qqt)

**Risk**

Possibility of something bad happening in the future

**Financial Risk**

Possibility of losing money on an investment or business venture.

**Volatility**

Degree of variation in trading price over time.

**Risk/ Reward Ratio**

Positive correlation.

Investor that takes higher risk **CAN** make higher rewards (but not guaranteed)

**Systemic Risk**

‘Market Risk’

Whole system/ market collapses

Cannot mitigate through diversification.

**Non- Systemic Risk**

Specific Risk

Only applies to specific investments, industries

Can mitigate through diversification

**Which type of risk can be mitigated through diversification?**

Non- Systemic Risk

Diversification doesn’t apply if whole system/ market collapse

**Types of Systemic Risk**

Inflation

Interest Rates

Currency

Political

Event

**Inflation/ Purchasing Power risk**

Inflation will undermine **real** cash flows of investment.

e.g. having 3% savings account when inflation is 6%.

**What asset classes does inflation risk apply to?**

All.

Cash-based investments more susceptible as only have one return – interest.

**Which assets are best inflation hedge**

Real assets

Shares/ property provide capital growth and income.

**Interest rate risk**

Returns harmed by variable interest rates

e.g. variable interest savings

**How to hedge against Interest rate risk**

Fixed rate savings/ bonds

**Re-investment Risk**

Won’t be able to match current interest rate with proceeds/ interest payments.

**Where does Re-investment Risk apply?**

Normally occurs with fixed income investments.

**What happens to credit spread when economic outlook is bad?**

More people buy gilts– prices up, lower yield.

Fewer people corporate bonds- prices fall, increases yield.

Therefore spread between yields widens.

**Bond Prices & Yield**

Price Up Yield Down

Price Down Yield Up

**Currency/ FOREX Risk**

Returns harmed by fluctuating exchange rates

e.g. EU investment but Sterling strengthens, returns will fall.

**Political Risk**

Mini budget

Brexit

**Event Risk**

Event that will adversely affect a company, industry, security.

Covid, Ukraine, natural disasters, regulatory change

**Types of Non- Systemic Risk**

Credit

Liquidity

Operational

Gearing

**Credit Risk**

Possible loss where borrower doesn’t repay loan/ meet obligations

**Downgrade Risk**

Ratings agencies to downgrade firm/state.

**Credit Spread / Yield Spread**

Difference in return between two bonds which are the same apart from credit rating.

10 Year Gilt with 10% Yield. 10 Year Corporate bond 8% Yield = 2% Credit Spread.

**Bail-in Risk**

Bondholders put at risk

Company or Country writes of debt or converts to less secure format – equities.

**Liquidity Risk**

Asset can’t be traded immediately without negatively affecting market price.

**‘Liquid assets’**

Cash

Shares blue chip companies

**‘Illiquid assets’**

Property

Shares small companies

**Operational Risks**

Risk of loss from failed people, processes, systems, External Events

**Operational Risk Examples**

Human error

Fraud

IT issues/ attacks

Personal issues- gender pay gap.

Strikes

**Counter-party Risk**

Form of operational risk

One of parties involved in transaction may default.

**Gearing risk**

Borrowing/ leverage Risk

Magnifies returns both gains and losses

**Gearing Calculations**

Number of shares x share price = total investment

Total investment – debt.

**Investor Risks**

Capital

Income

Shortfall

**Capital Risk**

Potential loss to all/ part of investment

Most things apart from cash under FSCS amount

**Income Risk**

Risk of reduction in Income stream

Lower interest rates – Variable cash savings

Lower dividends – Equities

Lower rent/ Void periods- Property

**Shortfall Risk**

If don’t reach target goal.

e.g. endowments

**How to diversify**

Invest **in and within** multiple asset groups

Gov & Corporate Bonds

Listed/ unlisted stocks

Residential & Commercial Property

**‘Fight to quality’**

Investors seek out lower risk assets in uncertain times.

More gilts, less corporate bonds, equities.