Farley & Thompson
STOCKBROKERS AND INVESTMENT MANAGERS

Risk and Diversification

What is Risk?

Risk is defined as the chance that an investment's actual return will be different than expected. It is therefore important to understand the relationship and trade-off between risk and return and the main factors that influence different investments.

Virtually all investment involves some degree of risk so it is crucial that you acknowledge and accept this and find a level of risk with which you are comfortable.

How much risk are you willing to take?

Your risk capacity relates to your ability to take risk. Generally an investor who has a high proportion of capital and income wealth relative to their liabilities, and who has a long investment time horizon, will be able to take a greater level of risk than someone with more limited wealth or a shorter time horizon.

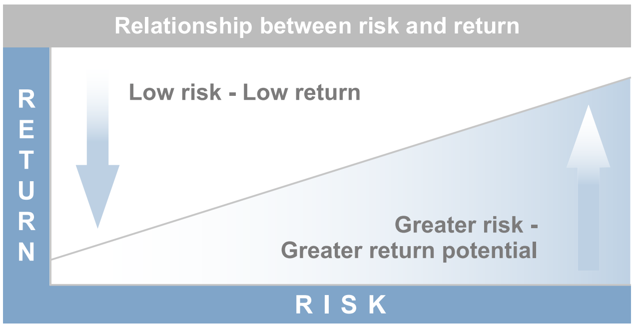
Your attitude to risk relates to your ability to tolerate market swings (volatility) as well as the chances of suffering a complete loss. The prospect of losing money will be very distressing for some whilst others will be more relaxed.

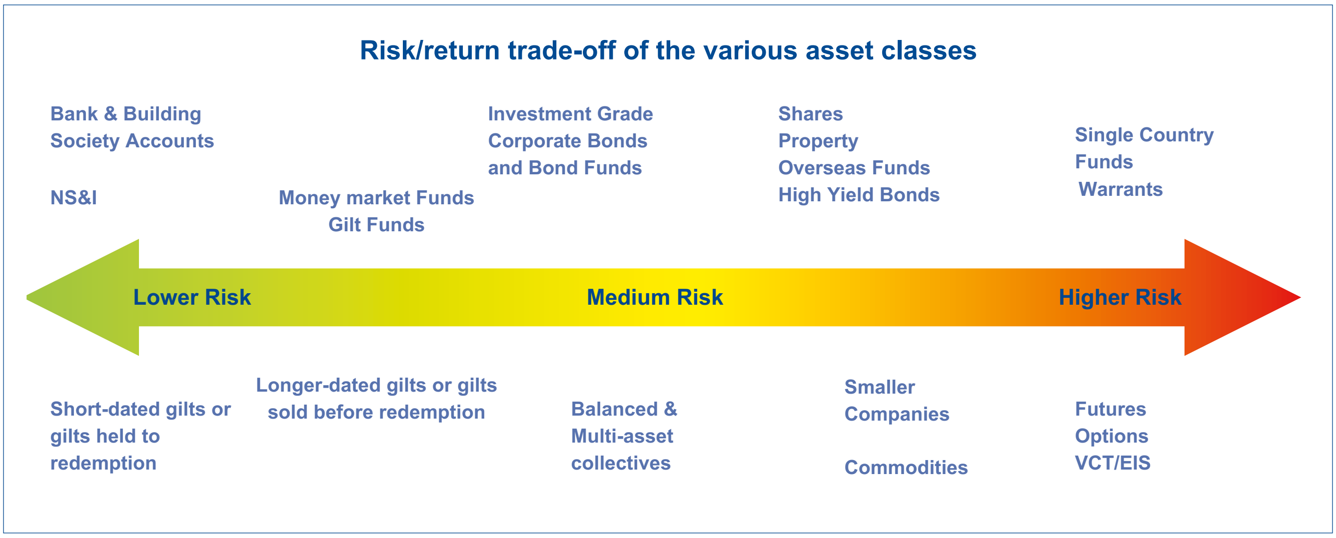
Both your ability to take risk and your attitude to risk may be influenced by your age and financial circumstances as well as other factors.

The principal forms of investment risk faced by investors are:

Systematic Risk - the risk that the overall stockmarket will rise or fall, as economic and other market factors change. This may affect returns over a period of time or have a more immediate impact if an investor buys at the top of the market or sells at the bottom i.e. bad timing. Systematic risk causes similar movements in all investment returns.

Unsystematic Risk – whereby different factors cause unrelated movements in the returns of different investments. Examples include industry risk caused by factors specific to a business sector rather than general to the market, and stock specific risk affecting one particular company.





No asset class, including cash, is considered to be absolutely risk free

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Attitude to Risk is personal to each investor. The following descriptions may help you to define your own attitude to risk.

If you consider yourself to be a Very Low risk investor

- You are unlikely to want to take any risk with your capital
- You will generally prefer cash-based products such as Building Society accounts and National Savings
- You view the security of your money as paramount, more so than the buying power of the money which would be reduced as a result of inflation

If you consider yourself to be a Low/ Medium risk investor

- You are likely to be cautious and concerned about security of capital but understand the need to protect it from the effects of inflation
- You are prepared to accept a small amount of risk to achieve modest returns
- You are unlikely to ever invest in direct shares but you are comfortable with collective investments, some of which may be invested internationally
- You understand risk and reward and know that your investments will fluctuate in value. You accept that it's possible to lose some of what you invest for the prospect of better growth

If you consider yourself to be a Medium risk investor

- You are prepared to take some risk in order to achieve your financial goals
- You are likely to want to invest in a way that does not expose all your capital to riskier investments as you don't like extreme volatility
- You are likely to want to spread your investments around, some of which may be outside of the UK
- You understand risk and reward and know that your investments will fluctuate in value. You accept that it's possible to lose some of what you invest for the prospect of better growth

If you consider yourself to be an Upper Medium risk investor

- You are likely to be familiar with investing and already have a proportion of your wealth in non-cash assets
- You are prepared to accept the higher levels of risk associated with direct equity investments
- You are likely to want to spread your investments around, some of which may be outside the UK
- You are familiar with most asset classes and are aware of the general risks associated with each
- You fully understand risk and reward and know that your investments will fluctuate in value. You accept that there's a real risk of loss of capital but this is balanced with the prospect of greater growth

If you consider yourself to be a Medium/High risk investor

- You are likely to be an experienced and knowledgeable investor used to taking substantial risks
- You will already receive a secure income from other sources
- You will be happy to invest in all areas and asset types and are looking for high returns
- You are likely to be attracted to less liquid investments such as the Alternative Investment Market (AIM)
- You fully understand risk and reward and know that your investments could be subject to extreme volatility. You accept that there's a real risk of loss of capital but this is balanced with the prospect of greater growth

If you consider yourself to be a High risk investor

- You will already actively manage your own investment portfolio
- You will be seeking to invest in the most speculative and volatile asset types such as stock and index futures and options, as well as derivatives and currency hedging
- You fully understand risk and reward and acknowledge that your investments could be subject to extreme volatility. You accept that there's a real risk of complete loss of capital on the most speculative investment transactions

What is diversification?

Diversification of risk can be simply described as "don't put all your eggs in one basket". Diversification can be used to moderate risk within a portfolio as individual investment variables may offset one another and this can be achieved in the following ways:

- Diversification of asset class (e.g. cash, fixed interest, equities, property, commodities)
- Diversification within the asset class (e.g. by sector, region or market)
- Diversification by product type (e.g. shares, investment trusts, unit trusts, OEICs or Exchange Traded Funds)
- Diversification by fund manager, product provider or investment strategy.

If you are planning to invest in the stockmarket you should:

- **Make sure you are prepared to accept some level of risk**
- **Ensure that you only invest what you can afford to lose**
- **Be happy to invest for a minimum of 5 years**

Over the years as your circumstances change it is likely that your investment objectives will alter and this in turn is likely to affect your attitude to risk. Please always let us know if your circumstances alter as it may affect the way we manage or advise you on your investments.