Building a portfolio (5)

How Risky Are Your Funds?

Here we consider different types of funds, and their investment risks as well as rewards. We identify three broad categories of risk - low, medium and high.

Please remember that past performance is not a guide to future performance. But history is useful in enabling you to explore what sorts of investments suit your circumstances and objectives.

lower risk

This lower risk category would include corporate bond funds, absolute return, international bonds, commercial property funds and also protected funds. You are prepared to accept some capital volatility for the potential of a better return than on deposit, but do not want the day to day risk of a stockmarket investment.

the reward: Over the last 10 years, the total return from a good mainstream corporate bond fund was 64% (net income re-invested), whereas on deposit it was 32%. Over longer periods our expectation is simply for a margin over deposit returns.

Corporate bonds continue to look attractive with interest rates close to zero.

the risk: Looking at a good lower yielding corporate bond fund, based on the last three years, in most months you should not see a fall in the capital value exceeding 2.5%*. This is the "monthly risk" figure.

Until 2008, the worst prior period was 1994/5. A typical lower yielding bond fund would have lost about 9% in 1994/5, and if you had been drawing income the fall in the capital value would have been more like 15%. In 2008 there were similar falls, though some funds lost in excess of 20%. As a guide, the higher the yield on the bond fund, the greater the potential downside.

medium risk

This category covers mainstream UK, European, and well diversified Asian funds. Plus global equity income funds. This is for those comfortable with stockmarket risk, meaning that you've probably lived through periods of extreme volatility before, and are comfortable taking a long view (at least 5 years).

the reward: Over the last 10 years, the total return from a typical, good, UK stockmarket fund (in this case an equity income fund) was 82% (net dividends re-invested), or 75% from a good fund in the UK All Company sector. In contrast, the deposit return was 32%, and the stockmarket index went up just 68% (again dividends reinvested).

the risk: Looking at a good fund in the UK All Company sector over the last three years, in most months you should not experience a fall in capital exceeding 9%*. This is the "monthly risk" figure.

Looking back over 10 years, we have still not recovered the peaks of 1999/2000. The falls began in early 2000 (down 43% at worst on the FTSE All-Share) and, despite a strong recovery through to 2007, and again in 2009, the index is still more than 30% below the all time high.

A typical good UK stockmarket fund would have lost a bit more than 30% in the period 2000-2003 though many were at worst down in excess of 40%, similarly in autumn 2008. Prior to that the steepest loss for our "typical good" fund was 14% in 1994, and it took 18 months to recover.

higher risk

This category includes tech, focussed Asian funds, emerging markets, smaller companies, and commodities. This means that, as well as being attracted to some years of 100% growth (such as with tech in 1999), you must also accept years of 50% losses, sometimes more, and take a 10 year view, at least.

Our experience is that high risk funds often do not provide the consistent year to year performance of something like a good mainstream UK stockmarket fund. Not only will you see the value 100% up and 50% down over relatively short periods, but for long periods (years) you may experience lacklustre performance, until it explodes upwards.

the reward: Occasional years of 100-200% returns.

the risk: In the higher risk area we can consider a number of sectors to illustrate the risks. Looking at a typical emerging markets fund, based on the last three years, the statistical analysis suggests that in most months you should not see a fall exceeding 13%* (much higher with some funds). This is the "monthly risk" figure.

Over the last 10 years the worst period for a typical Japanese fund was the 44% loss to August 1999. And 80%-plus losses have been experienced by tech funds.