Risk management -Is it integral to our financial planning?

by Jason Holmes, Lumen Financial Planning,

In business today there is much focus on risk management, ensuring that it is integrated into the process of how the organisation operates. This should ultimately reduce the threat of unwanted events happening and therefore avoid the associated costs which will hit the bottom line.

Likewise in financial planning, risk management should be core to all that is taking place to ensure that there are as few as possible unexpected events and that there are no unnecessary costs due to mistakes or poor decisions.

There are two main areas of risk management to focus on

Managing Risk within Investment

All investment, including cash, carries a level of risk and there are a number of risks normally associated with investments such as inflation risk, currency risk and market risk to name a few. However, there is a higher level of risk which an investor needs to consider carefully and make decisions on before they actually invest any money, namely;

Risk Tolerance – What level of risk can you live with? In other words what level of risk will mean you do not get a good night's sleep? We all have a different tolerance to risk which is primarily shaped by who we are and our experiences in life. This risk tolerance remains fairly constant though it can reduce as we get older.

You need to work out what risk you are willing to tolerate within your investments (and this includes pension investment). We recommend using a psychometric risk profiler to work out your tolerance and an individual can do this at www.riskprofiling.com. The result of this will begin to shape what your investment structure will look like.

Risk Required – What level of risk do you need to take? This is different from risk tolerance as it will be based on your financial and life objectives and the resources you have now and will have in the future. Based on your resources and what you are trying to achieve, what level of risk do you NEED to take to ensure you can achieve all that that you want to?

This should be absolutely central in what your financial adviser is talking to you about. If you have lots of resource and can meet your objectives by investing in cash then why take the risk of investing in other assets? If you do not have sufficient assets to meet your objectives and you need to take a higher risk than what your risk profile has shown you can tolerate, you need to have that discussion and work out a compromise. Do you take more risk, use more resources to meeting the objective or do you change the objective? A decision needs to be made on this.

Lifetime cashflow modelling will highlight the level of risk you need to take. I will discuss this in the next article.

Risk Capacity – What level of risk can you afford to take? Personally you may be able to tolerate a high level of risk and may need to take a high level of risk to achieve your objectives but do you have the capacity to take that level of risk? Can you afford to take it if it goes wrong?

For example a person may be five years from their desired retirement age but need to take a high level of risk to try to gain the returns needed to provide their desired income. In taking this high level of risk there is more potential for a bigger loss to be incurred and this loss would mean their retirement is delayed for a few years. Do they take this level of risk or do they compromise by taking less risk and reducing their retirement income or even delay retirement?

Conversely someone who is saving for an objective in 20 years time has a higher capacity for risk as there will be time to make up any losses that happen in the early part of the investment. Likewise someone who is saving regularly also will have a higher capacity for risk.

These three measures of risk are vital in your financial planning and your adviser should be discussing them fully with you before you make any investment.

Managing Risk through Protection

Protection such as life cover is another area in which risk management is used in financial planning. There is risk in many areas of our personal and business lives and if that risk can be quantified and a value put on it then protection can be used to help nullify the effect of it happening.

For example, within a company an individual who is key to the success of the business may be identified. The loss of that person can be quantified and life or critical illness cover could be taken on them by the business. This would provide funds to the business on the keyperson dying or having a critical illness and while it will not replace the person it will give the business funds to potentially cover loss of profits and the hiring of a new person.

Likewise within the family home it is usually an important objective of the family to ensure that they will be able to maintain their current lifestyle if the main earner prematurely dies. There is a big risk that they will not be able to do this without funds being available so life cover is taken on the person. The funds will not replace that mother or father but it will help the family maintain their lifestyle and reduce worry.

Like all areas of risk management I would recommend that you talk to a suitably qualified individual to assess your risk and advise accordingly.

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