

# KILLIK & Co

## Risks of Investments Guide

### Introduction

Killik & Co is committed to developing a clear and shared understanding of risk with its clients. The categories of risk set out within our Terms & Conditions explain what you can reasonably expect in terms of the level of investment risk to which your investments may be exposed through any of the Firm's services.

Please remember that the attitudes to risk of different investors can vary significantly. You are urged to contact the Firm without delay if you have any questions or concerns relating to the risks to which your investments may be exposed. Killik & Co can provide you with advice on your options for managing the risk of your investments.

**This document provides a brief description of the nature and risks of the following range of investments, which are available through our stockbroking and wealth management services:**

1. Shares – UK and overseas
2. Bonds – government and corporate fixed interest securities
3. Unit Trusts and Open Ended Investment Companies (OEICs)
4. Investment trusts
5. Structured Products
6. Warrants and options
7. Contracts for Difference and Spread Betting
8. Hedge funds
9. Unquoted investments

**It is important that you understand that there remains risk with all investment and that you may not get back the original capital invested. The value of your investments may fall as well as rise, and the past performance of investments is not a guide to future performance.**

You should also understand that any investment, even cash carries risk, if risk is defined not by the face value of cash, but by its purchasing power. Inflation at only 3% erodes the purchasing value of cash by 50% in 23 years, whereas an inflation rate of 5% achieves the same effect in only 14 years and reduces it by almost 75% in twenty five years.

### 1. Shares

You can buy shares as part of a pooled investment or directly, when you buy through the stockmarket. Shares are also known as equities or stocks.

When you buy shares direct in a company, you are buying a part of that company, and you become a shareholder, which usually means you have the right to vote on certain issues. You can either buy new shares when the company starts up and sells them to raise money (through an Initial Public Offering or a rights issue), or buy existing shares which are traded on the stockmarket.

The aim is for the value of your shares to grow over the longer term as the value of the company increases in line with its profitability and growth. In addition, you may also receive dividends, which is an income paid out of the company's profits. Longer-established companies usually pay dividends whilst growing companies tend to pay lower, or no, dividends (with these you would typically be hoping for better capital growth).

## **Risk**

The level of a stockmarket goes up or down as the prices of the shares that are the constituents of that market go up or down. The main factor determining the price of a share is the perception of its current value to its owner.

One factor that could affect the price of a share is a change in opinion as to how well the company itself is performing or could perform in the future. This opinion is frequently based on predictions about the economic conditions in which a company is operating, which is why it might seem that stockmarkets go up or down depending on economic conditions.

If you are investing in shares you should expect the value of your investment to go down as well as up, and you should be comfortable with this. Holding a limited number of equities that do not provide adequate diversification can result in this risk being exacerbated, and investors in individual equities should be particularly aware of the risks inherent in such an investment strategy (i.e. the Specific Risks of those securities). Killik & Co categorises single equities as higher risk, and equity investment, by way of a diversified portfolio of equities as either Medium or Higher risk.

If you have a wide range of shares (a diversified portfolio) you are very unlikely to lose all your money. It is important to stress that you need to be looking to the long term when investing in shares – at least five years but preferably longer (more than ten years). The FTSE 100 Index commenced at a base value of 1000 on 3<sup>rd</sup> January 1984.

**Foreign shares:** If you are investing in overseas companies, you will also be subject to Currency risk as a result of exchange rate fluctuations. For example if you buy US dollar denominated stock and the dollar declines against the pound, then the sterling value of the stock will decline, even if the actual dollar share price remains the same. This can therefore impact the performance of your portfolio as a whole.

## **2. Bonds or Fixed Interest Securities**

A bond is a loan to a company, government or a local authority. Generally, interest is paid to you as the lender and the amount of the loan repaid at the end of the term, providing it is redeemable. There are many other names for this type of investment, for example,

- loan stock
- debenture
- debt securities
- gilts (loans to the government), and
- corporate bonds (loans to companies).

The main benefit of these investments is that you normally get a regular stable income. They are not generally designed to provide capital growth.

Bonds have a **nominal value**. This is the sum that will be returned to investors when the bond matures at the end of its term. Most bonds have a nominal value of £100.

However, because bonds are traded on the bond market, the price you pay for a bond may be more or less than £100. There are several reasons why the price might vary from the nominal value, for example:

- If a bond is issued with a fixed interest rate of, say, 8% and general interest rates then fall well below 8%, then 8% will look like a good yield and the market price of the bond will tend to rise – perhaps from £100 to £110 or £120.
- The reverse is also true. If interest rates rise, the fixed rate of a particular bond might become less attractive and its price could fall below £100.
- Ratings agencies might take the view that a particular company's bond no longer qualifies for a high rating – perhaps the company is not doing as well as it was when the bond was issued. If this happens then the market price of the bond might fall. On the other hand, the company's rating may be improved leading to a price rise.
- The inflation rate might start to go up and the interest rate on some bonds might start to look less attractive compared with other investments.

## **Risk**

If you ignore the inflation risks outlined above, bonds are generally less risky than having a share in a company. One of the main risks is that the company you have lent money to can't pay the interest due or cannot pay the money back at the end of the term.

It is generally considered that these risks do not apply to gilts – a government is expected always to pay in full – though there have been instances of certain countries having been unable to repay. Bonds issued by governments will usually pay a lower rate of interest as a result of the perception that they are less risky.

Companies have different credit ratings and a company with a high credit rating is regarded as safer than a company with a lower credit rating. Companies with a lower credit rating will have to offer a higher rate of interest on their bonds than companies with the top credit rating, simply to attract investors and to compensate for the higher risk.

Bonds can be bought and sold in the market (like shares) and their price can vary from day to day. A rise or fall in the market price of a bond does not affect what you would get back if you hold the bond until it matures. You will only get back the nominal value of the bond in addition of course to any coupon payment to which you've been entitled during your ownership of the bond, irrespective of what you paid for it. If you paid less than the nominal value then you will have made a capital gain when the bond matures; and a capital loss if you paid more than the nominal value.

This only applies if you buy a single corporate bond. It doesn't apply to bond funds, because these invest in many different bonds so there is no single maturity date for your investment.

## **3. Unit Trusts and Open Ended Investment Companies (OEICs)**

Unit trusts and OEICs are the most common form of Collective Investment Schemes in the UK. These are funds run by fund management companies. In Europe they are called UCITS schemes, which are permitted under European legislation to be sold in the UK.

They are called **open ended** as the number of units/shares in issue increases as more people invest and decreases as people take their money out.

As an investor, you buy units/shares in the hope that the value rises over time as the prices of the underlying investments increase. The price of the units/shares depends on how the underlying investments perform.

You might also get income from your units/shares through dividends paid by the shares (or income from the bonds, property or cash) that the fund has invested in.

**Charges:** When you buy units/shares in a fund, you usually pay an initial charge. How the charge is shown depends on how the price is worked out.

For most unit trusts, you buy units at the offer price and sell them at the bid price. The bid price is lower than the offer price and the difference is called the bid/offer spread. These funds are referred to as being **dual-priced**. The initial charge is usually part of the bid/offer spread, which can often be around 5%. Killik & Co has negotiated a reduction down to the creation price on a large number of funds, so please speak to your broker about the charges that will apply to specific investments. Some funds have no initial charge, but there may be an exit charge instead when you withdraw your money by selling units.

For OEICs, there is no difference between the buying and selling price of units. Because of this, the funds are referred to as being **single-priced**. If there is an initial charge, it is added to the single price when you buy units, and there may also be an exit charge when you sell units. Between them, these charges are likely to represent around 5% of your investment, so you may end up paying the same level of charges in a single-priced fund as in a dual-priced fund. Again Killik & Co has negotiated a reduction down to the creation price on a large number of funds, so please speak to your broker about the charges that will apply to specific investments.

The fund management company takes an annual management charge directly from the investment fund. There are also other costs – buying and selling within the fund, custodian fees etc. These costs, along with the annual management fee, are called the **total expense ratio** (TER). The TER is therefore an estimate of the total ongoing costs of the investment.

Brokers, such as ourselves, often receive a Service Fee, otherwise known as trail commission, from the fund management company. This commonly amounts to about 0.5% of the value of the investment.

## **Risk**

Open-ended investment funds generally invest in one or more of the four major asset classes - shares, bonds, property and cash. Most invest primarily in shares but a wide range also invests in bonds. Few invest principally in property or cash deposits. Some funds will spread the investment and have, for example, some in shares and some in bonds. This can be useful if you are only taking out one investment want to spread your investment across different asset classes.

The level of risk will depend on the underlying investments and how well diversified the open-ended investment fund is. For example, a fund which invests only in one industrial sector, such as technology, will invariably be more risky than funds that invest across the whole range of companies in a market.

Some funds might also invest in derivatives, which may increase the risk profile of a fund. However, fund managers often buy derivatives to help counterbalance or cancel out the risk involved in owning assets or in holding assets valued in other currencies.

Your money in an open-ended investment fund is protected by a trustee or depository who ensures the management company is acting in the investors' best interests at all times.

As with shares, if the fund you invest into is denominated in a currency other than sterling, exchange rate movements will impact upon the value.

#### 4. Investment Trusts

An investment trust is a company with shares, and another form of collective investment scheme. Unlike an open-ended investment fund, an investment trust is **closed-ended**. This means there are a set number of shares available, and this will remain the same no matter how many investors there are. This can have an impact on the price of the shares and the level of risk of the investment trust. Whereas open-ended investment funds create and cancel units/shares to suit the number of investors, closed ended investment funds do not, therefore a buyer needs to find a seller and vice versa, a seller needs to find a buyer.

**Charges:** Because of the need to match buyers and sellers, the shares of an investment trust are generally traded on the Stock Market, in the same manner as the shares of any other company. You usually pay stockbroking commission when you buy and sell investment trust shares. The difference between the prices at which you buy and sell (the **bid/offer spread**) is a different charge from that of open ended funds. This is the price that all investors pay to the market makers when trading on the Stock Exchange. The institutions that provide the liquidity to the market, make their money by the difference between the buying price and the selling price on all quoted securities. There is also an annual management fee which comes out of the investment fund.

#### Risk

The price of the investment trust shares depends on two main factors:

- The value of the underlying investments. In this respect it works in the same way as open-ended investment funds.
- The popularity (or unpopularity) of the investment trust shares in the market.

This second point applies to investment trusts but not to open-ended investment funds or life assurance investments. The reason is because it is closed-ended – it has a fixed number of shares. If there is a high demand for particular investment trust shares then it will be possible to sell them at a higher price than if there are few people willing to buy them.

The result is that investment trust shares do not simply reflect the value of the underlying investments, they also reflect their popularity in the market. The value of the investment trust's underlying investments is called the **net asset value** (NAV). If the share price is exactly in line with the underlying investments then it is called **trading at par**. If the price is higher as the shares are popular then it is called **trading at a premium** and if lower, **trading at a discount**. This feature may make them more volatile than other pooled investments (assuming the same underlying investments).

**Gearing:** Investment Trusts are also able to borrow money to invest, which is called **gearing**. Gearing improves a trust's performance when its investments are doing well. However, if its investments do not do as well as expected, gearing lowers performance – for example:

If the investment trust is made up of £50m of investors' money and £50m of borrowing then the total fund available for investment is £100m.

Say the value of the fund goes down by 10% as a result of losses in the stockmarket – the value of the overall fund falls from £100m to £90m.

However, bear in mind that the borrowing is still £50m and so the remaining £40m belongs to the investors.

Although the overall fund went down by 10%, the investors' money has gone down by 20% (ie from £50m to £40m). So gearing boosts gains, but also magnifies losses.

Not all investment trusts are geared and deciding whether to borrow and when to borrow, is a judgement the investment manager makes. A gearing figure of 100 means that an investment trust is not geared. Any figure over 100 shows the proportion of its total investments that is borrowed. For example, a gearing figure of 120 means that borrowed money amounts to one-sixth of a trust's total investments.

An investment trust that is geared is a higher risk investment than one which is not geared (assuming the same underlying investments).

## 5. Structured products

These are usually share-based investments from banking, life assurance or investment management firms. They can be offered as open-ended investment funds, life assurance investments or even (technically) cash deposits. If the investment does not perform as well as expected you could lose some or all of the money you invested (your capital). Capital-at-risk investments, high income investments or guaranteed stockmarket investments are all types of structured products.

Capital-at-risk investments are usually offered as a special investment available for a limited time, typically a couple of months. They usually have a fixed term which tends to be around five or six years. Each investment works in a different way but there are two main formats:

- **High income.** These investments offer a high level of income, usually more than a bank or building society account. This income is usually fixed for the term. However, the return of your capital at the end of the term is not guaranteed. You would usually only get all your money back so long as, for example, the stockmarket had not gone down more than a stated amount. If the stockmarket falls by more than the stated amount, you will get back less than your original investment at the end of the term. You should make sure you fully understand the amount you could lose before investing in a structured product.
- **Stockmarket growth.** This works in almost exactly the opposite way. With these investments your original investment is usually guaranteed at the end of the term. You do not get income, you get capital growth only. The part that is not guaranteed is how much growth you get. This is usually based on stockmarket returns, for example you may get back the rise in the FTSE100 index (the index of the top 100 UK firms). You don't however receive the dividend income that you would receive if you owned the shares in the stockmarket directly or through an investment in another type of pooled investment.

For more information about these products and their risks the Financial Services Authority has produced a factsheet - *Capital-at-risk products* - which is available from their consumer website: <http://www.moneymadeclear.fsa.gov.uk/>

## 6. Warrants & Options

Please note, you will not be able to trade in warrants, options or futures unless we are satisfied that you have adequate knowledge and experience to fully understand the nature and risks of these investments. If you are interested in these types of investments please contact your broker for further information.

**Warrants:** A warrant is a time-limited right to subscribe for shares, debentures, loan stock or government securities and is exercisable against the original issuer of the underlying securities. A relatively small movement in the price of the underlying security results in a disproportionately large movement, unfavourable or favourable, in the price of the warrant. The prices of warrants can therefore be volatile.

It is essential for anyone who is considering purchasing warrants to understand that the right to subscribe which a warrant confers is invariably limited in time with the consequence that if the investor fails to exercise this right within the predetermined time-scale then the investment becomes worthless.

Transactions in off-exchange warrants may involve greater risk than dealing in exchange traded warrants because there is no exchange market through which to liquidate your position, or to assess the value of the warrant or the exposure to risk. Bid and offer prices need not be quoted, and even where they are, they will be established by dealers in these instruments and consequently it may be difficult to establish what is a fair price.

**Options:** these are securities that convey the right, but not the obligation, to engage in a future transaction on an underlying security at a fixed price. For example, a call option provides the right to buy some amount of a security at a set strike price at some time on or before the expiration date, while a put option provides the right to sell. The decision on whether to exercise the right to buy or sell will depend upon the value of the underlying security at the time and whether this will result in a profit or not.

### Risks

Buying options involves less risk than writing options because, if the price of the underlying asset moves against you, you can simply allow the option to lapse. The maximum loss is limited to the premium, plus any commission or other transaction charges.

If you write an option, the risk involved is considerably greater than buying options. You may be liable for margin to maintain your position and a loss may be sustained well in excess of any premium received. By writing an option, you accept a legal obligation to purchase or sell the underlying asset if the option is exercised against you, however far the market price has moved away from the exercise price. If you already own the underlying asset which you have contracted to sell (where the options will be known as 'covered call options') the risk is reduced. If you do not own the underlying asset ('uncovered call option') the risk can be unlimited. Only experienced persons should contemplate writing uncovered options, and then only after securing full details of the applicable conditions and potential risk exposure. **We will not accept transactions for 'uncovered' call options.**

## 7. Contracts for Difference and Spread bets

Please note, you will not be able to trade in warrants, options or futures unless we are satisfied that you have adequate knowledge and experience to fully understand the nature and risks of these investments. If you are interested in these types of investments please contact your broker for further information.

**CFDs:** these are geared or leveraged instruments. When trading a share via a CFD, instead of paying the full consideration a margin payment from as little as 5% of the value of the contract may be paid. Consequently you can hold a position up to 20 times greater than would be possible with a traditional investment. Anticipating the right price movement will magnify profits. Conversely, losses can rise commensurately if the price moves against you. CFDs are available on the shares of most listed companies in the UK and major economies around the world as well as indices, gold, silver, energies, commodities, interest rates, foreign exchange and more.

In addition to buying an equity CFD and “going long”, investors can sell shares they don’t actually own, or “go short”, in anticipation of buying back at a lower level and profiting from a price fall. Other than shareholder privileges, a CFD reflects all corporate actions affecting the underlying share. The net dividend is paid to the holder of a long CFD on the ex dividend date, while holders of short CFDs pay the net dividend.

### **Risks**

CFDs are leveraged products that can lead to large gains but can also quickly result in losses that exceed your initial deposit. CFDs may not be suitable for everyone, so please make sure that you fully understand the risks involved. The potential risks mean that our CFD service is only available to those clients with a sufficient level of investment experience and understanding.

**Spread bets:** Spread bets are by their nature high risk investments. They are based on a simple concept. If you think that a financial market or product will rise in value, then you may want to buy it (go long). If you think that a certain financial market or product will fall in value, then you may want to sell it (go short).

Once you have bought a financial market or product that you believe will rise in value, then in due course, if your prediction is correct, you can sell the market or product for a profit. (If you are incorrect and the value falls, you make a loss.)

Once you have sold a financial market or product that you believe will fall in value, then in due course, if your prediction is correct, you can buy the market or product back at a lower price, for a profit. (If you are incorrect and the value rises, you make a loss.)

The spread is the difference between the buying and selling price of a financial market or product. It represents the market-maker’s potential profit or loss on a transaction.

### **Risks**

Financial Spread Betting carries a high level of risk, therefore you should only speculate with money you can afford to lose. Financial Spread Betting prices can be very volatile and the resulting losses may require further payments to be made. It is not suitable for all customers and requires that you fully understand the risks involved. The potential risks mean this service is only available to those clients with a sufficient level of investment experience and understanding.

## **8. Hedge Funds and unregulated collective investment schemes**

Hedge funds are exempt from many of the rules and regulations governing other types of funds, which allows them to accomplish aggressive investing goals. Hedge funds’ activities are limited only by the terms of the contracts governing the particular fund. They can follow complex investment strategies, being long or short assets and entering into futures, swaps and other derivative contracts.

### **Risks**

Hedge funds may be geared or include risky or volatile investments such as derivatives. Whilst some hedge funds may be designed to work in the opposite direction to the market (thereby

providing protection against falling values in other assets that you may hold), others may not be and the title of hedge fund could therefore be misleading. You should make sure you understand the objectives and risk of the particular fund before investing.

### **9. Unquoted Investments**

These are shares (usually in small companies) which are not listed on a Recognised Investment Exchange. Companies listed on AIM (Alternative Investment Market) are also classified as 'unquoted'. AIM provides an opportunity for companies to raise capital for expansion, a trading facility and a way of establishing a market value for their shares.

As at September 2007, there were over 1,680 companies trading on AIM. The market cap of the index varies quite widely. One of the advantages of investing in certain AIM companies is that AIM shares which qualify for Business Property Relief (BPR), once held for two years, would normally sit outside of your estate for Inheritance Tax purposes.

#### **Risks**

AIM investments typically carry a higher degree of risk than investing in more liquid shares of larger companies. There is a risk that you could lose the entire amount of your investment. Also, AIM companies tend to trade on wider spreads than companies on the main market, and liquidity can be a problem.

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The descriptions in this document have been drawn largely from the Financial Services Authority's Consumer website: <http://www.moneymadeclear.fsa.gov.uk/> Please contact your broker with any queries about investment risk.