Invest...don't gamble

Thomas Dickson gives some financial advice

The markets are always volatile and reactionary - one week going up (“FTSE up 5.16 per cent due to Euro Aid package for Greece”) and the next, plummeting (“FTSE loses £100bn in a week.”).

So, should we really worry about short term trends and does it matter to the average dental professional who might be considering investing in the stock market?

If you are a day trader or one of those rare dentists who likes to indulge in a spot of spread betting or FOREX trading, then financial speculation based on guesses about future outcomes is bound to excite you. However, what you’re really doing is gambling. This can have its rewards but also clearly puts you at a greater risk of experiencing financial losses.

Investing in the stock market does not have to be about gambling, though. Those interested in reaping more modest but steadier rewards need to be prepared to play the long game. For the majority of people, this option holds far more appeal.

Recent research conducted by Morningstar looked at investments made in the UK stock market over a series of 10 year increments spanning the period between 1984 and 2009. The survey revealed that on average, during each decade, investors never lost their money. Put another way, had you invested during any one of the 181 possible 10 year time frames, you would not have lost money.

My advice would therefore be to ignore all the hype surrounding the latest ups or downs in the market and consider those investment returns that can be made over the long term.

However, the way you choose to invest is largely down to preference. Which brings us to another matter: risk tolerance.

Risk Tolerance

People react differently to risk. Some see it as an opportunity; others, as a threat to their security. Still others are prepared to take risks in one area of their life, but not in others. Risk tolerance is the level of risk a person will willingly accept and is best thought of as a continuum ranging from risk-avoidance to risk-seeking behaviour.

Earlier, I mentioned the day traders and speculators. Who enjoy trading in the short term, clearly, this type of investor has a high risk tolerance. However, research shows that the majority of people are more risk-averse than risk-seeking. Faced with a choice between a certain profit and an uncertain but probably larger profit, a sizeable majority chooses the certain (but probably smaller) profit.

Given the results of the Morningstar study, it would seemed that caution is well-placed and a more conservative approach involving lower risk investments, over the long term is much less likely to lose you money.

However, the whole issue of financial risk is a difficult one. On the one hand, low risk tolerance prevents many people from doing as well as they could financially. On the other, some of life’s most unpleasant financial surprises arise when people expose themselves to a level of risk beyond that of their comfort zone, i.e. their risk tolerance. It therefore depends very much on your risk tolerance profile - a psychological trait that can now be measured using psychometric profiling techniques.

Although psychological profiling has not with it’s share of controversy, it is now widely accepted as a useful tool for assessing people’s overall behavioural tendencies. This includes investment risk, which can now be measured using Risk Profiling systems such as Finametrica. If you are interested in learning more about your risk profile, you should contact your independent financial adviser, who may well have access to such tests.

Types of investment

Risk tolerance naturally determines the type of investment people feel most comfortable in making.

Investments usually take the form of one of two types: unit trusts and shares. In terms of risk, the latter usually involves more risk than the former.

Because investment shares are a more direct form of investment - buying shares in a listed company, for example, their market value can fluctuate fairly substantially. This makes them a slightly riskier form of investment than unit trusts, which spread risk by buying shares in a range of companies, which is then managed through one fund.

As an investor, you would buy units in that particular unit trust fund and hope that the difference between the performances of high and low risk shares helped to balance out the overall value of each unit over time. However, it is worth noting that the overall degree of risk you take will depend on the investment strategy of the trust: is it in established companies or smaller, riskier emerging markets?

Clearly those investors who are risk-averse would be advised to not only opt for longer-term investments, but also consider investing in unit trusts, rather than shares.

So, assuming that you are able to invest in the stock market, and hold on to that investment for ten plus years, and are willing to ignore those commentators who think you should sell this tomorrow or buy that now, you’ll probably end up making some money.

At that stage, your main problem will be how to reduce the tax on your capital gains – but that is the subject of another article, especially if the government decides to raise the thresholds in this area.

The figures above are for guidance only to reflect the position at the time of writing. The value of investments can go down in value as well as up. It is therefore important that you understand the risks and your commitments.

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About the author

Thomas Dickson, born in Hong Kong and studied at Aston University Birmingham and in Tokyo. Thomas started working as a financial adviser in 1995, became an independent financial adviser in 1996, and is now a director of Essential Money Limited. Essential Money provides independent financial advice to dentists throughout the UK. Thomas has the Advanced Financial Planning Certificate from the Chartered Insurance Institute and is a Certified Financial Planner. For advice, call Essential Money on 0121 485 5806, email Thomas@essentialmoney.co.uk or visit www.essentialmoney.co.uk.