



ASSESSING INVESTMENT RISK

A Coalface Training Guide

When I was a young accountant, many - far too many - years ago, the senior partner of our firm had some guidelines for assessing investment risk.

“There is only one true interest rate” he would say “and that is 3% per annum. To this, add the current CPI rate, as a compensation for the reduction in value of money.”

“If CPI is 2.5%, the “no-risk” return is 5.5%.”

“If an investment is returning 7%, you are being paid 1.5% for risk. If the return is 10%, you are being paid 4.5% for risk - 3 times as much - in compensation for the eventual loss of the money that you have invested.”

In fact, a 1.5% risk margin on a 7% investment equates to a loss of the capital invested about once every 25 years. (The \$1.50 extra interest every period per \$100 invested, if reinvested, amounts to \$100 after about 25 years.)

On this basis, a 4.5% risk margin equates to a loss of the capital invested every 12 years.

If the investment is still sound - after properly assessing the risk - then go for it.

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