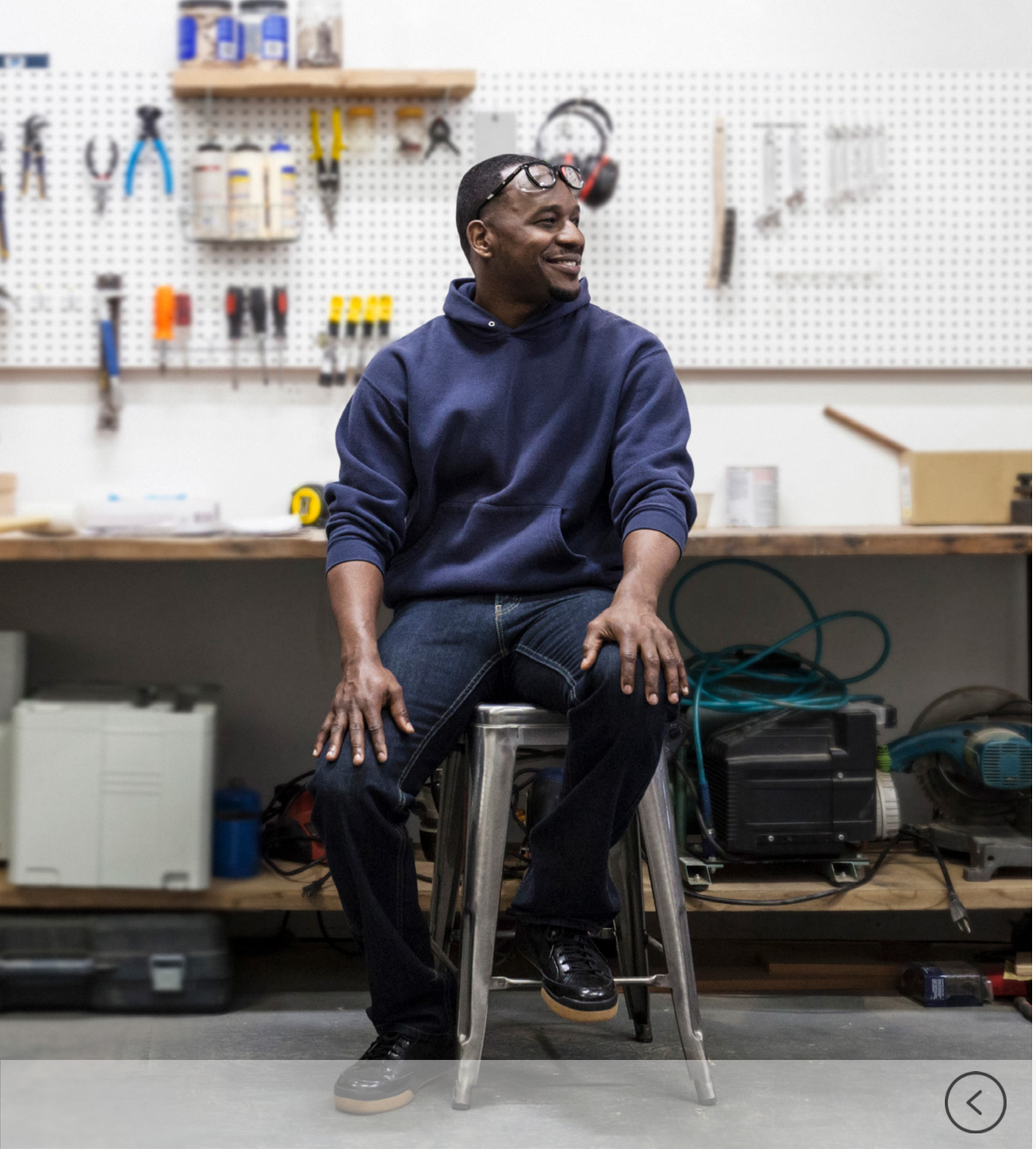
Pension portfolios: how to balance risk vs return

Creating a balanced pension portfolio can give you more control over how your money is invested and how it's performing. In this guide, we look at a few things you could consider to help you strike the right balance.



Introduction

Your pension's top priority is to give you **enough money to live the life you want** in your retirement.

Typically, a pension will be made of different types of investments. Having **the 'right' combination of these investments** can help you manage market ups and downs over time and hopefully **grow your pension pot** steadily.

Remember the value of all investments can go down as well as up and you may get back less than has been paid in.

Into your pot goes a dash of this and a splash of that

A typical pension portfolio invests in assets through investment funds. These funds can be invested into a mix of equities (shares), bonds (fixed interest) and cash investments, but they can also be invested into other things, like raw materials (commodities), commercial property and foreign currencies. In the market, all these investments – or 'asset classes' as they're referred to – perform differently in terms of risk and potential for growth:

Equities (shares or stocks)

Share values align with a company's performance and are typically amongst the more 'volatile' types of investment, meaning they're at a higher risk of falling sharply and suddenly. However, they do have the potential to achieve better returns over a longer period.

Bonds

These are loans to governments (UK government bonds are known as 'gilts') or companies that provide a set rate of interest over a set period. These investments generally produce more stable returns and work well in a portfolio with shares to balance out the day-to-day market risks that shares face.

Cash/money markets

Investments in cash or cash equivalents are seen as pretty safe and unlikely to suffer dramatic losses. Their downside is they don't make high returns and their growth may not keep pace with inflation, meaning they may lose value in real terms over time.

Property

These funds usually invest in commercial property, and make money from rental income and property sales. They offer the potential for steady returns and growth in the longer term, but high transaction costs and changes in property valuations can impact them.

There’s no one-size-fits-all solution

Your circumstances, age, when you want to retire and how much capital you’ll need, along with how much risk you’re comfortable taking, all have a bearing on investment decisions.

Take, for example, a single 25-year-old enjoying a well-paid, steady job with no dependants. They might feel comfortable with the risk of having a higher proportion of shares – the riskier option – to bonds in their portfolio. However, a 50-year-old with a family, who wants to retire in 10 years, may be more cautious and want to ring-fence assets with a portfolio more weighted to bonds than shares. This is because the closer they get to retirement, the less time their investments have to recover from any sudden drops in value.

The art of diversifying

Along with choosing an asset class balance that fits you, you should be sure you have enough diversity in those individual classes.

When you invest in shares, you should have a mix of different stocks and sectors because they’ll each perform differently over time. For instance, a combination of British and overseas stocks could help to weather market storms that hit some areas harder than others, helping to keep up the overall growth potential.

Values in the balance

People's interest in how their money is being invested has changed over the past decade or so. Pensions are now including ESG funds in their options - **ESG stands for environmental, social and governance**.

These investments avoid putting money into industries or companies viewed as problematic in these criteria, for example gas and oil. Instead, funds are put into more environmentally friendly businesses, such as solar and wind power, and responsibly-run companies with good working and production standards.

Thinking long term

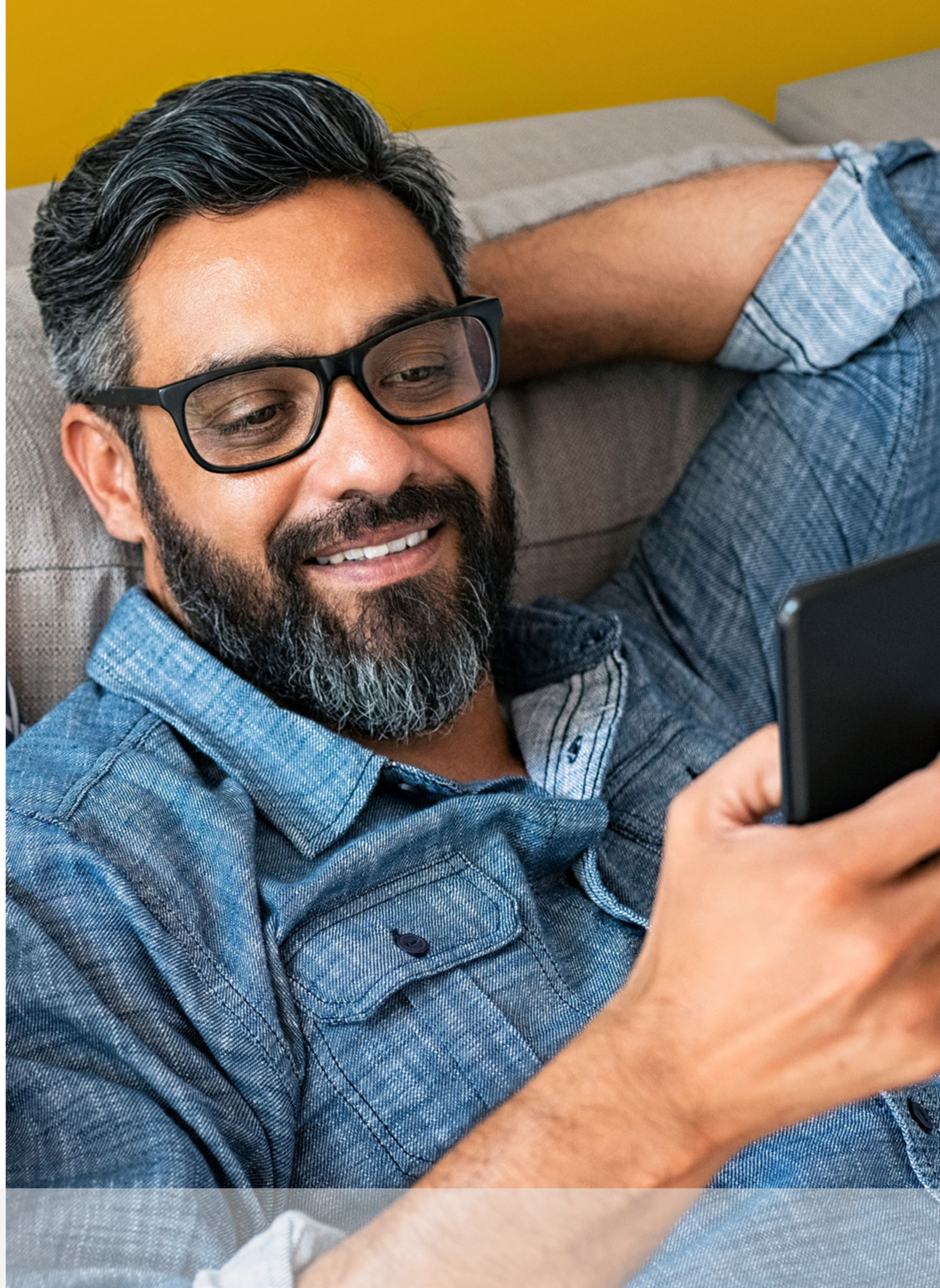
Your pension is a long-term investment and asset classes naturally become unbalanced as markets rise and fall over time. That's why it's important to keep an eye on yours periodically and rebalance it if necessary. The aim of this is to make sure levels remain in line with your circumstances and risk tolerance.

For example, your portfolio might be split 65% shares and 35% bonds and cash – but if the stock market takes a hit, your bond allocation will suddenly make up a greater proportion of your overall investment value.

Instinctively, you might want to rush to sell the low value shares before things get any worse and invest more in the bonds. However, buying more shares while they're low value and reducing your bond allocation might reap better long-term returns once the stock market bounces back.

Start your own balancing act

If this has piqued your interest and you want to find out more about your pension and how your money is invested, talk to your provider or your financial adviser. If you have a workplace pension speak to your employer.



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