This Is the Biggest Financial Risk You Will Ever Face

Description

While there are plenty of risks in the financial world, there is one which poses a greater threat than all others. It has the potential to destroy wealth over a long period and leave even the most cautious, risk averse investor with little to show for a life of hard work. Furthermore, the effect of compounding only exacerbates the problem and it is almost ever-present throughout all of our lives.

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The biggest financial risk you will ever face is, of course, inflation. This may come as something of a surprise, since many people may feel that a loss of income, recession or falling asset prices may be more significant risks than inflation. However, with those risks, the likelihood is that in the long run they will cease to exist. In other words, a loss of income is only likely to be temporary, asset prices have nearly always recovered in the long run and recessions give way to economic booms. However, inflation is nearly always in the background, slowly destroying wealth.

Of course, inflation makes investing much more difficult than it otherwise would be. That's because it makes doing nothing not an option over the long run. For example, many investors are more focused on avoiding losses than on making money from their investments. Therefore, they keep a significant proportion of their wealth in cash at all times, which provides them with a low return on capital but a high degree of certainty regarding a return of capital.

The problem, though, is that most of the time cash returns are lower than inflation. That's especially the case if cash returns are taxed. This means that over time, the spending power of an investor's capital declines until eventually, it is almost worthless. Therefore, there is direct cost of being a risk averse investor, since it means that in the long run you are almost guaranteed to lose out. As such, inflation puts pressure on all investors to seek a higher return and this also means that risk is increased.

For example, over a 30 year period where inflation averages 3% per annum, an investment would lose almost 60% of its value. This assumes a zero return on the original investment and serves to show that without taking any risk with their capital, investors are practically guaranteeing that their portfolio will be worth progressively less in real terms in future. Unlike other risks facing investors, inflation tends to last over a long period of time. In fact, it is usually assumed to be a constant feature of the financial world.

Therefore, the best way to combat inflation is to achieve a return in excess of rises in the price level. One simple and straightforward way of doing this is to invest in high quality shares when they trade at fair prices. Often, their yields will be enough to stave off the effects of inflation, while the capital growth can be viewed as an excess return above and beyond that required to maintain the purchasing power of your investment.

Unless a return which at least matches inflation is recorded, in the long run the end point is a loss. As such, beating inflation should be viewed as the priority for all investors in the long run.

CATEGORY

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