FINANCIAL PLANNING I INVESTMENT ADVICE
SUPERANNUATION I SMSF I RISK INSURANCE I ESTATE PLANNING

Understanding Risk

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What is risk?

In any investment some degree of risk is unavoidable – but what is "risk"?

The chance of loss

The Cambridge English Dictionary defines risk as "the possibility of something bad happening". A sound financial plan will acknowledge your attitude to risk, and consider this to determine strategies and investments that are aligned.

Many individuals define it by asking the question: "What is the likelihood of me not achieving my goals?"

Many investors define it by asking the question: "What are the chances of losing my money?"

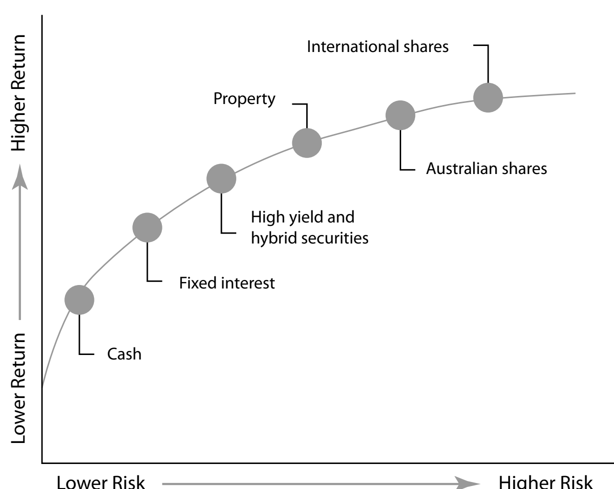
Variability and volatility

Australian investment magazine, Moneymanager[1] defines risk as "the variability of returns." This definition is closer to that used by investment professionals. Fund managers and professional investors see risk as the difference between expectations and results.

A common sense definition

Neither of these two definitions is exactly correct in an investment sense. However both may define your attitude to risk – and that's just as important.

Putting it differently again, risk is the price you pay for returns. Just as the more work you do the more you should be paid, so the more risk you take, the higher the return you may receive. This is "the risk/reward trade-off".



The simplest way to illustrate this is with examples:

- A bank account is a great example of a low-risk investment. It's guaranteed by the government so there is almost no chance that you will lose your investment and the value of your investment won't fluctuate wildly. The downside is that the potential return from investing your money in a bank account is quite low.
- You could increase your potential return by investing in a term deposit instead of a bank account, however that will increase the level of risk slightly. Your money is locked away for a period of time which means you can't access it if you need it or if a better investment opportunity comes along.
- Shares are a classic example of a high risk, high return investment. If you invest in shares, the value of your investment will change every minute of every day; sometimes quite significantly. In addition, it's possible to lose your investment entirely if the company you're invested in collapses. On the positive side, the share market in general has shown impressive performance over the long term.

1 Source: www.moneymanager.smh.com.au/tools/glossary/dict_r.html

Can risks impact achieving goals and objectives?

Yes, they can. A critical part of determining appropriate strategies for you is to understand your goals and objectives, both financial and lifestyle. We value having a deeper awareness of where you have been, where you are and where you want to be and believe this knowledge plays an integral part in creating a suitable, tailored financial planning roadmap. Along with investment risks associated to underlying assets or the timing of your investment, a number or risks can also impact you in achieving your goals and objectives. Some more general risks include inflation risk, economic risk, political risk and short-fall risk

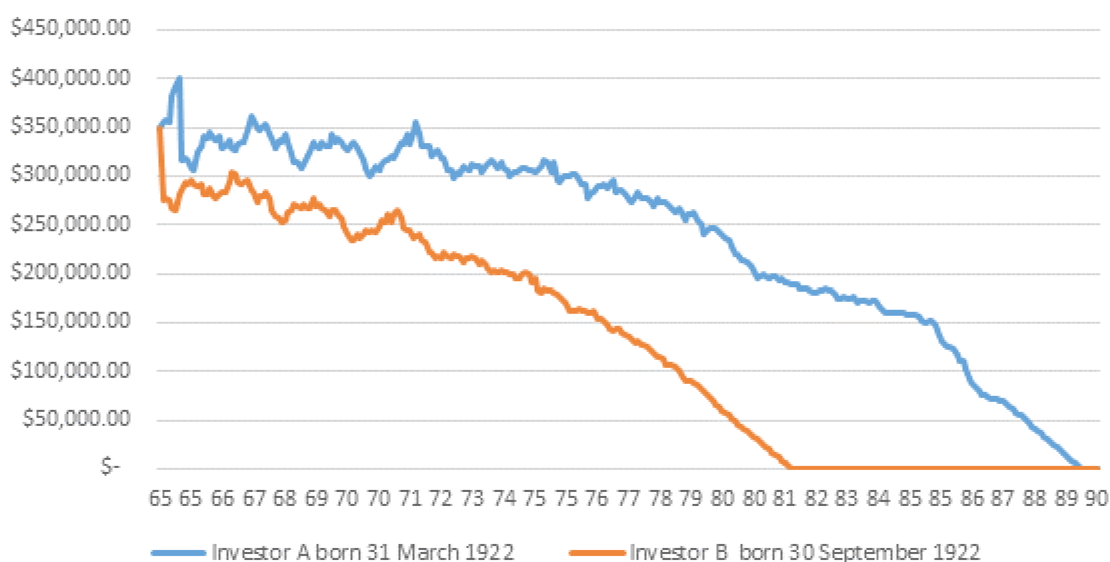
Longevity risk

Longevity risk is the risk that an individual outlives their savings and subsequently has their lifestyle meaningfully impacted. This risk has changed over time as a result of increasing life expectancy and longer duration in retirement, drawing on savings accumulated during a person's working life. Longevity risk can be reduced in a number of ways if appropriate for an individual – by retiring later, doing part-time work in early retirement, having greater exposure to growth assets, reducing annual spending in retirement, saving more during employment, or investing for total returns not just the income from a given investment.

Sequencing risk

Sequencing risk is an investor's risk that the order of returns while they are withdrawing funds from their pool of assets with reduce how long the assets last, compared to how long they were anticipated to last based on average return expectations. Sequencing risk can be more sensitive to market changes throughout certain stages of your life, e.g. during retirement. This type of risk can be reduced by not having an overly aggressive portfolio, ensuring that total returns are maximised for the level of risk taken i.e. considering growth and income needs, or portfolio diversification. The chart below shows the outcomes of two investors born six months apart retiring at 65 with $350,000 each invested half in cash and half in Australian shares, drawing $35,000 per year as a pension. A large decline in the market immediately after retirement at age 65 has a significant impact on how long an investors' money lasts when compared to the same sequence of returns occurring 6 months later.

50% Australian Shares 50% Cash



Source: Morningstar using Bloomberg AusBond Bank Bills index and S&P/ASX 300 Accumulation Index

How can you manage investment risk?

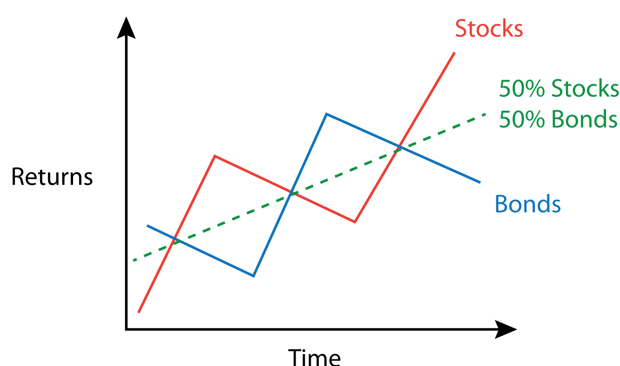
With an understanding of what you can expect from different investments and how they interrelate, we can employ some simple but powerful strategies to accept some risks and reject others in order to manage risk.

Diversification

In simple terms, diversification means 'don't put all of your eggs in one basket'!

Because different investments have different risk and return characteristics we can tailor a portfolio that balances your tolerance for risk and your need for investment returns. By spreading your investments across a range of asset classes you can reduce your investment risk and smooth out your returns because under normal circumstances when one part of your portfolio is not performing as well as expected, the other assets may help to balance the overall return.

A well-diversified portfolio helps you ride out the ups and downs of financial markets by spreading your money across different asset classes. It will leave you less exposed to a single economic event, so if an asset class isn't performing well, you won't lose all of your money. Of course the opposite also applies, if an asset class is performing well the total return you can expect will be reduced, or averaged out by the underperforming investments. The following charts shows this effect in its simplest form.



Diversification is also important to be considered within asset classes, as differences in returns exist from varying drivers. For example within shares those related to resources, financials and telecommunications will have different returns to each other.

When choosing a mix of investment options the nature of the portfolio as a whole and the potential investment earnings will depend on the combination of options you choose. The table overleaf describes some of the characteristics generally associated with each of the major asset classes.

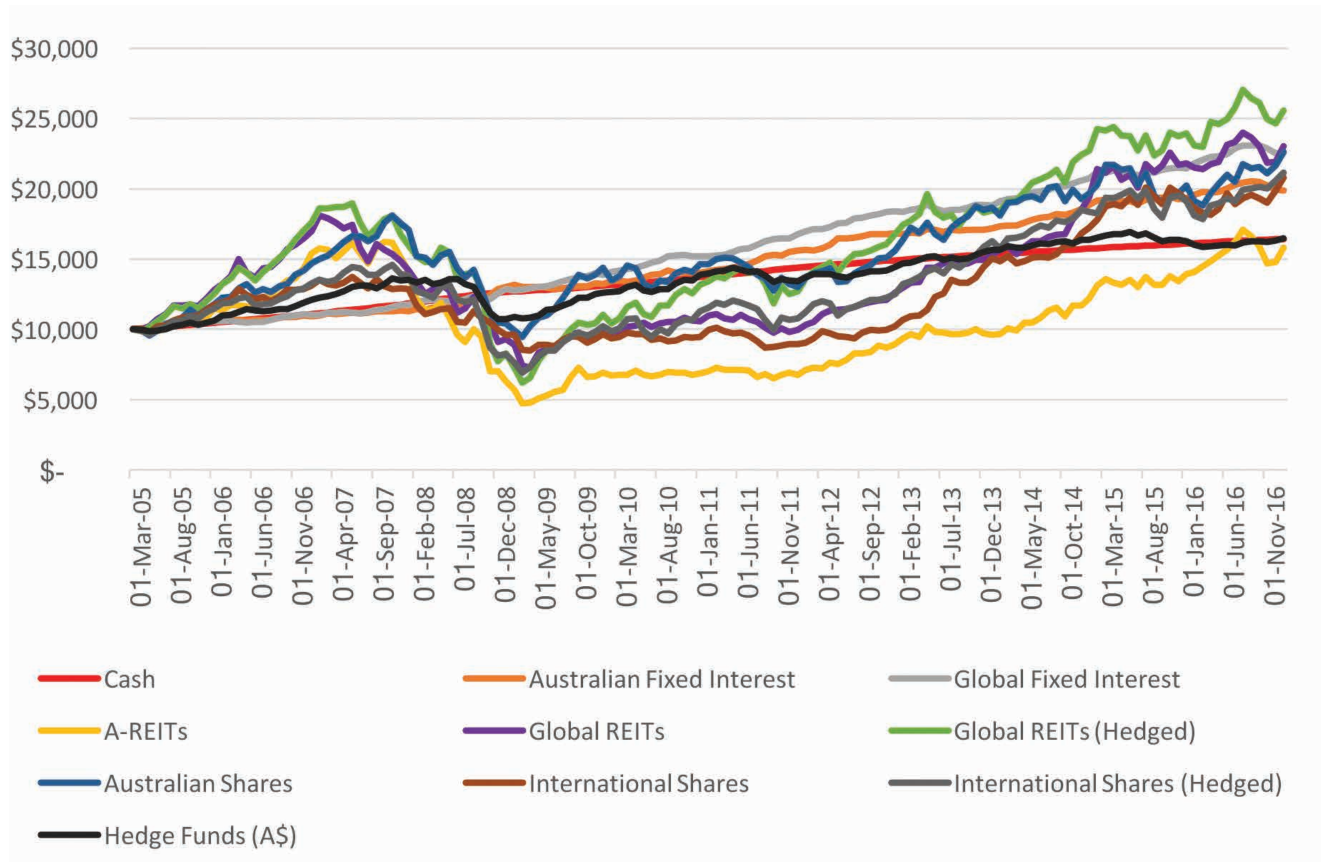
Asset class summary

Asset Class	Features	What do I need to know?
Cash Money in bank deposits Money in short-term money market securities	Income return comes from interest paid on the amount invested. Growth returns can also come from increases or decreases in value of the underlying securities due to changing interest rates.	Chance of losing money on a cash investment considered remote over a one-year period, but possible. Generally a stable investment that provides steady returns. Returns tend to be lowest of all asset classes over time. Short-term money market securities can increase or decrease in value over time due to changing interest rates, unlike money in bank deposits.
Fixed Interest Bonds Debentures	Income returns come from interest paid on the ‘loan’ amount. (When buying fixed-interest securities, investors are ‘lending’ money to a corporation or government at an interest rate.) Growth returns also come from increases or decreases in value of the underlying securities due to changing interest rates. Assets held to maturity have no growth return as the principal is paid back at the end of the term.	Tend to provide better returns than cash over the long term, but lower returns than property and shares. Value tends to fluctuate more than cash but less than property and shares.
Property Industrial, retail or commercial real estate Unlisted property funds Listed property trusts	Returns come from increases or decreases in value. Income returns come from income in the form of rent. Returns from listed property are linked to movements in the value of the securities and income generated by the property management companies.	Potentially earn more than fixed interest and cash over the long term, but less than shares. Value tends to fluctuate more than fixed interest and cash but not shares (particularly unlisted property and less so for listed property), over time.
Alternative investments Infrastructure, such as roads and airports Private equity investments	Returns come from increases or decreases in value. Returns also come from income.	Potentially earn more than property, fixed interest and cash over the long term. Value tends to fluctuate more than property, fixed interest and cash in the short term. Considered a medium-to-high risk investment.
Shares Securities that represent ownership in a company	Returns come from increases or decreases in value. Returns also come from income from the company’s profits which are paid to shareholders as dividends.	Potentially earn the highest return over the long term. Value more likely to fluctuate in the short term. Considered a high-risk investment.

Asset class performance

The historical performance chart shown below illustrates that assets experience volatility no matter their perceived risk, and the resultant outcome may provide improved or poorer returns for investors also taking into consideration additional variable factors. Past performance should never be considered an indicator of future performance of any financial investment.

Performance of $10,000



Source: Morningstar Bloomberg AusBond Bank Bills index, Bloomberg AusBond Composite 0 + Years, Barclays Global Aggregate TR Hedged AUD, S&P/ASX 300 A-REIT Accumulation Index, FTSE EPRA/NAREIT Developed Total Return AUD, FTSE EPRA/NAREIT Developed Total Return Index hedged AUD, S&P/ASX 300 Accumulation Index, MSCI World Index Net Return AUD, MSCI World Index Hedged, DJ Credit Suisse Hedge Fund Index AUD

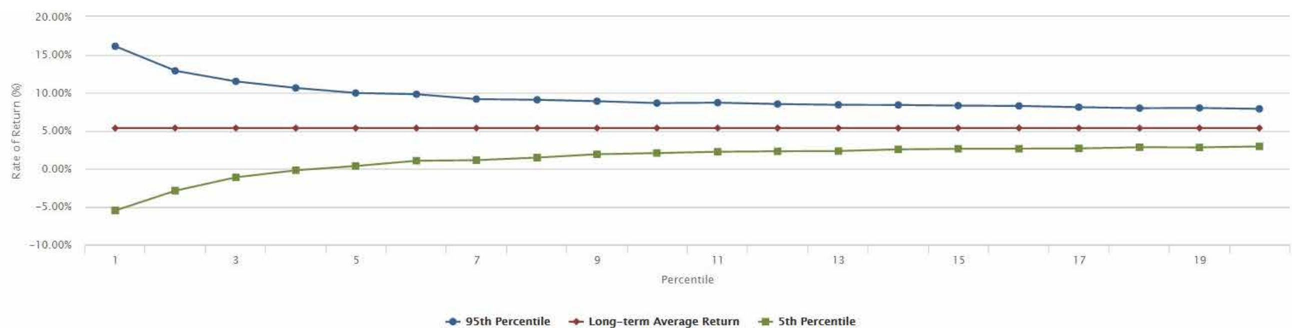
Time in the market

Many people believe investing is about 'timing the market' – getting in before prices rise, enjoying the ride up and then getting out before prices fall.

But a more important factor in achieving returns is being prepared to spend 'time in the market' – this is because over time the effects of the short term rises and falls are averaged out such that the longer your portfolio is invested the narrower the range of potential returns you can expect.

The following graph shows the long term return expectations for a diversified portfolio with a 60/40 split of growth and defensive assets. It shows that over time the range of returns – that is the difference between the best and worst you can expect – gets closer together the longer you invest. Even allowing for the portfolio to achieve the worst possible return each year, holding on for 5 years would see you portfolio still make a positive return.

Range of returns over 20 years

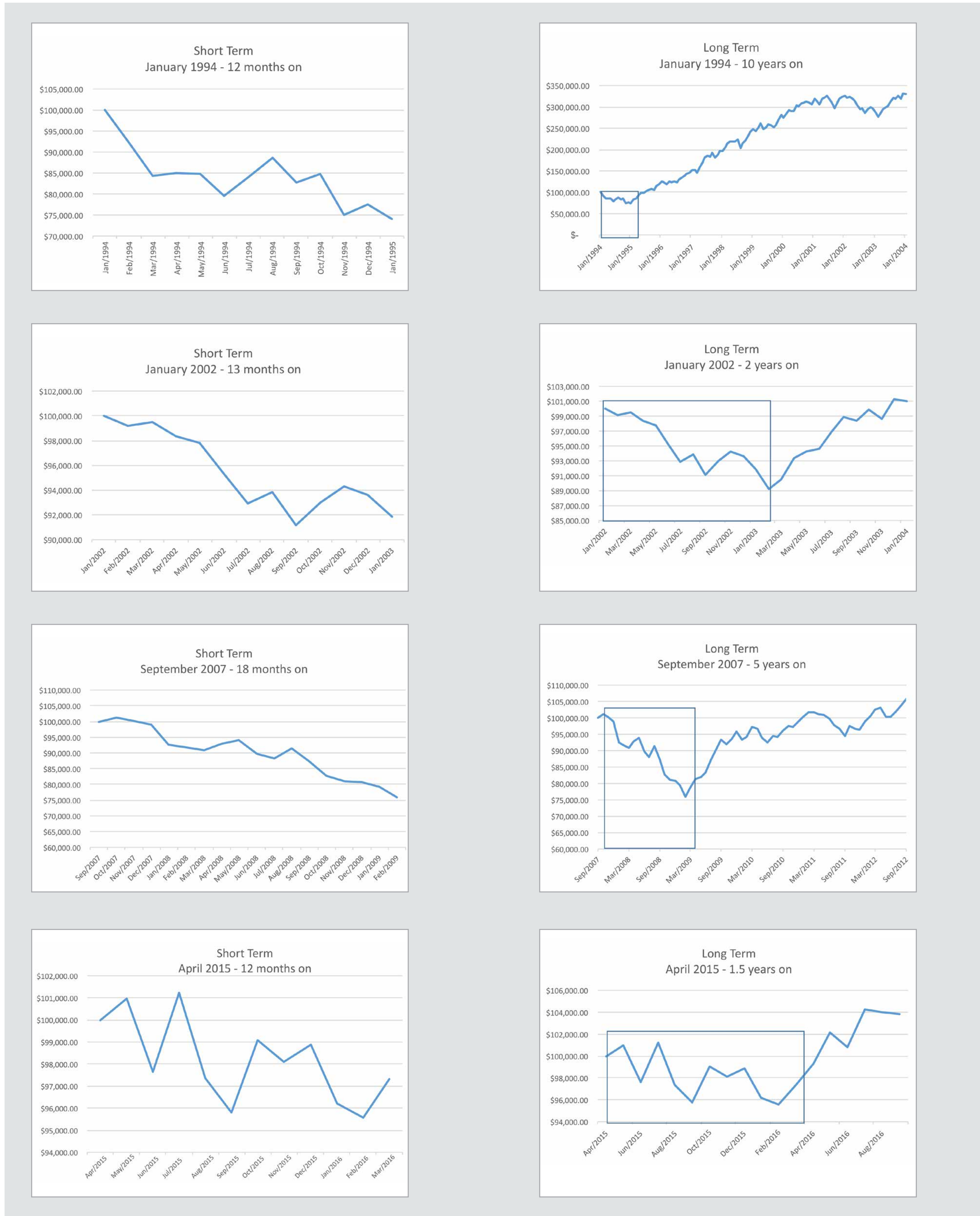


Despite this, it can be a difficult strategy to maintain in time of downturn as it can be tempting to sell an investment if its value falls. However history proves that having the discipline to stick with quality investments is generally a more successful strategy over time.

The following graphs cover some of history's major market downturns. They show how an investor in a balanced fund would have fared if they held onto their investment rather than crystallizing their losses when market prices dropped. The long-term results all prove the value of staying the course through the market ups and downs.

Investment horizons

The length of time that an investment is held will impact the potential gains or losses that are incurred by an investor. The below charts illustrate that performance of an investment will vary greatly, dependant on the time period that is being reviewed.



Source: Morningstar. Graphs prepared by IOOF Research based on assumptions of $100,000 initial investment in Australian shares (45%), International shares (20%), Bonds (30%), Cash (5%) with all income reinvested and rebalanced monthly. Fees have not been included in the representations above.

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