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Understanding investment risk

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When you invest, you are putting your money 'at risk' even if you put it in a bank account. The challenge is to know what risks you face and to look to manage the potential consequences of the risks. It is normally better to decide how to do this in advance and not when the risks happen.

The term **risk** means different things to different people. For many, it is something they want to avoid. For others, it is an opportunity and an acceptable part of everyday life. For investors who are prepared to take on and manage risk, there are potential benefits in the form of higher returns.

What is risk

In simple terms, risk is a measure of the chance that an investment will not be as good as you expected it to be, or were told it should be. It means you might not get back some or all of your money, you might not get as much income (e.g. interest) as you thought, or you might lose your purchasing power and not be able to buy what you need. It may also mean that the overall investment experience is unsettling.

Understanding risk

Understanding the potential negative consequences of an event on an investment is important. If the consequence of an event happening is unacceptable, it is best that the risk is not taken on or, if taken on, is closely managed. Managing those that are relevant, is a necessary requirement to achieve your goals. Unmanaged risks present barriers to achieving the financial goals and ultimately may result in you needing to save more, or having less to spend.

Every investment has some potential risk. The risk might result in:

- A low or negative return (i.e. a loss) for a period, that gives cause for concern
- Earning less than you expected, or could have earned elsewhere and so more is required to be saved

The investment process

Investing is a process that starts with an investor's current financial situation, determines their goals and establishes a plan to achieve them.

The plan to achieve the goals will involve future savings levels, an investment strategy and a risk management policy. Because investment outcomes, particularly over the short-term, are uncertain, part of the plan must also be to periodically review the progress towards the goals.

For a given financial goal, there is a link between the required savings level and the different levels of investment return. The higher the investment return, the lower this required savings level and vice-versa. The outcome of the review will be to change the savings level and/or the investment strategy overtime to increase the likelihood of achieving the financial goals.

In most cases, the goals will be expressed as "achieving a particular level of assets at a future date (e.g. retirement)". However, while often expressed as a dollar amount of assets at retirement, the goals are probably better defined as "achieving a particular level of income each year throughout retirement".

There is also a link between the investment return and the investment strategy (mix of cash, bonds, property and shares). The investment strategy therefore is the mix of cash, bonds, property and shares to achieve the required income each year and the risk is a measure that this required income level is not achieved.

The legal stuff
This is not an investment statement for the purpose of the Securities Act 1978. An investment statement is available from SuperLife free of charge. Before making a decision to invest, you should consider whether you need to seek financial advice. If you wish to have personalised financial advice, you should talk to an appropriately experienced Authorised Financial Adviser.

- Having to sell at a loss when the market is down, making it a permanent loss
- Earning less than the rate of inflation rate, so your future buying power reduces and these may be made worse by:
- Picking a poor financial adviser or investment manager
- The particular style of the investment manager i.e. how they make decisions
- Concentrating your investments in a few assets or a single manager and not monitoring them closely
- Having leverage in your portfolio (i.e. borrowing to invest).

Long-term inflation is often the real risk

While many investors focus on the risk that the value of their savings goes down next year ($100 becomes $90), often the real risk is inflation (i.e. $100 buys fewer goods).

Inflation is the rate at which the prices increase over time. The effect of this is to reduce the buying power of your money. While your money may not go down in absolute terms, you can only buy fewer goods. For example, if you put $1,000 under your mattress today, it would only have the spending power of $781 in 10 years' time, at 2.5% inflation each year. It is important to allow for inflation when working out how much money you'll need in retirement or how you will invest your money.

Value of $1,000 in ten years' time, at different inflation rates

Inflation (% p.a.)	Value of $1,000
0.0%	$1,000
2.5%	$781
5.0%	$614
7.5%	$485
10.0%	$386

Time horizon is important

Your investment horizon is fundamental to the risk/reward trade-off. The longer the investment horizon, the more short-term uncertainty you can expose yourself to, i.e. the higher up the risk return curve you can go. However, you are never guaranteed, to get a higher return by taking on investment risk and the "long-term" may require 30 to 40 years.

If there is not a high level of confidence for the potential of a higher return, it may not be worthwhile taking on the risk. Often, the lack of confidence is due to the time horizon being too short for the higher return to emerge.

You should also consider your willingness to take on risk.

Willingness to take on risk

It is important to have the right level of risk. Taking on more risk than needed, can be as bad as not taking on enough. Both can result in insufficient wealth and require a higher savings level. Choosing the right level of risk involves understanding your ability to take on risk (your risk tolerance) and your willingness to take more or less risk than is theoretically right for you, i.e. your attitude to risk (or risk preference).

Your attitude to risk generally determines the type of investments you will choose to invest in. There are a number of factors that will affect your attitude to risk:

1. Your current assets relative to the level required to achieve your goal – this measures how much risk you can absorb from a particular investment without comprising the achievement of the ultimate goal.
2. Your level of secure or "safe" investments. If some of your total assets are part of a safety buffer, riskier long-term investments can then be added to this base without long-term adverse consequences from short-term events.
3. Your income and future earning capacity – generally, the higher your income, the greater your ability to cope with risk and respond to events.
4. Your age and 'investment horizon' – a long investment period often means you are able to absorb short-term ups and downs. The issue is then one of whether you want to.
5. Your past experience of investment and any losses suffered in particular.
6. Your personality – if your personality leads you to worry whatever the circumstances, a low-risk investment strategy may be best.
7. Your partner's view, if your investments are part of a wider family plan. The views of each partner are therefore important.

But some risks, e.g. inflation cannot be avoided. While the short-term ups and downs of the sharemarket are often the main concern, as it can lead to a low average absolute return, for many, inflation is the key risk when determining a long-term retirement investment plan.