A guide to investment risk

Understanding investment risk is the key to developing a successful investment plan. While every investment has potential risks, they can be managed and minimised.

Everybody worries about risk. By getting the right guidance you can keep risk in perspective and identify the types of risk that are acceptable and those that are best avoided.

Permanent loss of capital

This is the risk that you probably fear most – the thought of losing all of your money.

It's this risk which gets most of the newspaper headlines, but in reality it's the risk which can most easily be avoided.

The key to managing this risk is to buy only quality investments and to buy a number of investments so that if one does fail, it will only have a small effect on your overall portfolio.

So, should you accept the risk of permanent loss? Are the rewards worth the risk? The answer is yes and no.

No, you shouldn't accept the risk of loss of capital associated with poor quality investments. The risk is too high, and the rewards are often illusionary.

But, yes, you should consider accepting the risk of loss of capital associated with high quality investments. The risk is low, and the potential returns are acceptable. Moreover, the risk can be minimised with the help of a diversification strategy.

Fluctuating returns

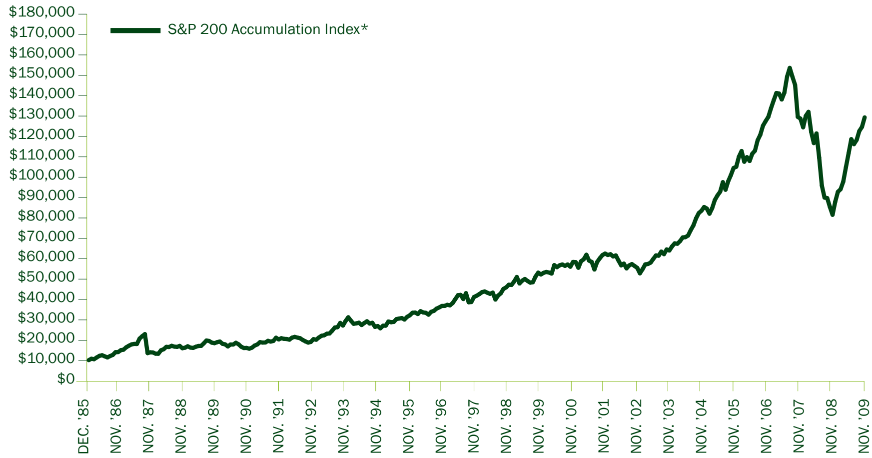
In one way or another, all investments suffer from this risk.

The asset class which fluctuates the most is shares; their values can change on a minute-by-minute basis. Even over longer timeframes, share returns can fluctuate strongly.

The key is that the returns from quality investments will fluctuate upwards more often than they will fluctuate downwards. In so doing, they will reward you with a superior return over time. As Graph 1 highlights, despite short-term volatility, the value of the Australian share market has increased substantially over the past 17.5 years.

Graph 1: Australian Share market always bounces back

Following a fall, the market has never failed to rise above the previous high point



Source: Investment Solutions, Bloomberg

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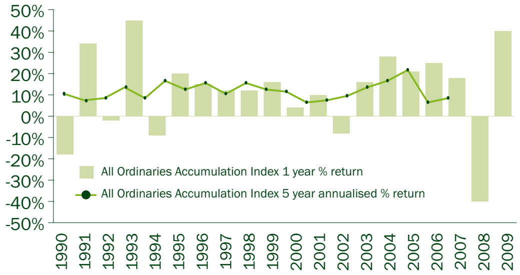
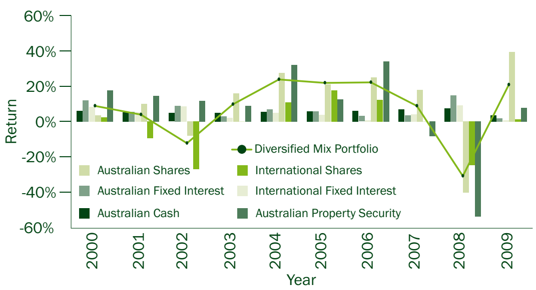
Graph 2: Investing for the long-term reduces risk

Australian All Ordinaries Price Index to period end 31 December



Source: Advance Investment Solutions

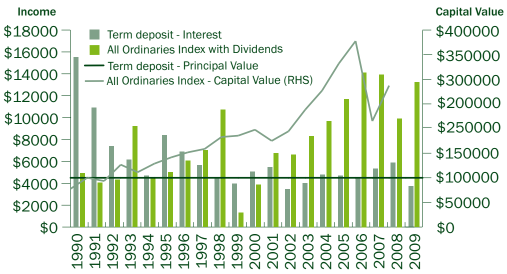
Graph 3: Return for Diversified Mix versus each asset class (last 10 years)



Source: Iress, DataStream and St.George Investment Solutions

Graph 4: Return on investment of $100,000

Invested from January 1990 to December 2009



Source: Advance Investment Solutions

You can minimise the risk to your portfolio of fluctuating returns by:

- investing in quality investments
- investing for the long term
- diversifying your investments.

Graph 2 shows how investing over a longer timeframe reduces risk. The Australian share market has had a number of negative single-year returns since 1990.

However, the graph shows that keeping your investment for five or more years substantially reduces the risk of negative returns – there hasn't been a single negative five-year return in this period.

The third way to minimise risk is to diversify your investments.

Graph 3 shows how a diversified portfolio smooths your return. The line is the return you would have received had you invested in a basket of all the asset classes rather than any particular one. You can see that the highs and lows have been smoothed out along the way, providing you with a more consistent return.

Not achieving your goals

This risk occurs when you don't use investments which will generate a sufficient return to meet your financial goals. It typically occurs when you decide to 'play it safe' by investing in cash and term deposits to ensure that you don't lose capital.

However, this can sometimes lead to a worse fate – not having enough money to achieve your goals.

Graph 4 shows the difference in the long-term returns of investing in term deposits compared with industrial shares. The income and capital value generated from the share portfolio outperforms that of the term deposits.

Things you should consider

This publication provides an overview or summary only and it shouldn't be considered a comprehensive statement on any matter or relied upon as such. This publication doesn't take into account your personal objectives, financial situation or needs. It's important for you to consider these matters before making any financial decision.

Speak to your financial adviser. They will help you work out what level of risk you're comfortable with and recommend investments that will bring you closer to your goals. Your financial adviser can give you a copy of the relevant Product Disclosure Statement for any financial product you are considering and you should read this document carefully before making any investment decision.

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