

## **Risk and Return**

In constructing your portfolio, it is important that you understand the risks associated with the investments that are chosen.

### **What do we mean by Risk?**

Risk and Uncertainty are different. The possibility that things may not turn out exactly as you expected is Uncertainty. Risk, to some may mean the possibility of losing a portion of your capital. For others, the risk of your assets not producing enough income on which to live may dominate your concerns.

Risk and Uncertainty cannot be eliminated. However, they can be measured and managed within your portfolio. The key is to determine the *appropriate* level of risk for you. Taking on greater uncertainty and short-term risk may be necessary for you to gain the long-term returns needed to achieve your lifestyle goals and objectives.

### **What are the types of Risk?**

There are a number of risks to be considered when constructing your portfolio:

- Investment Market Risk is the possibility that all investments in a market sector, for example, Shares, will be affected by an event.
- Investment Specific Risk is the possibility that a particular investment may under perform the market or its competitors.
- Inflation Risk is the possibility that your investment return is below the inflation rate, which reduces the spending power of your money.
- Credit Risk is the potential failure of a debtor to make payments on amounts they have borrowed.
- Interest Rate Risk is the possibility that your investment will be adversely impacted by a fall or rise in interest rates.
- Legislative Risk is the possibility that a change in legislation will impact the appropriateness of certain investments for you.
- Liquidity Risk relates to the ease with which you can sell or liquidate your investments. Some investments impose Exit Fees or have limitations on your withdrawals. Other investments may be difficult to sell due to a lack of buyers.

### **How do you cope with Risk?**

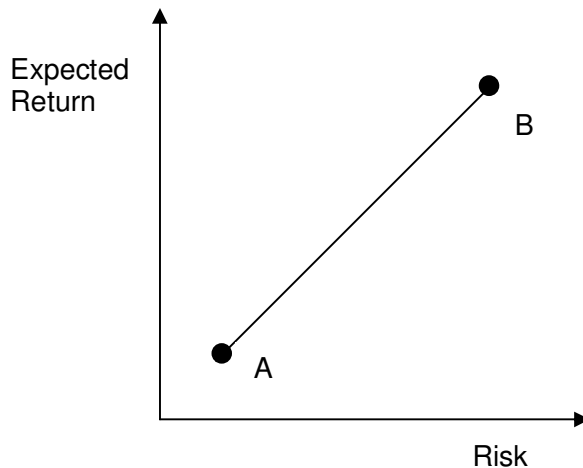
In considering an investment strategy, you need to understand the risks that you may be exposed to and how they will impact your personal situation. Assessing risk and potential investment return should be in the context of your goals and the time that you have to achieve your objectives.

### **The Relationship between Risk and Return**

Risk and Return are closely related. In general, the higher the degree of risk associated with an investment, the higher the return that will be required by investors to accept this

risk. Low risk investments, such as cash deposits, offer relatively low returns as a reflection of their greater security, and are better suited to risk adverse investors. This is called the Risk/Return Trade-off, and is used as a guide to selecting the appropriate asset allocation for your portfolio.

The meaning of risk is abstract and subjective. For some, risk refers to the likelihood of an absolute loss of capital, while for others it can refer to the level of *volatility* of an investment, which means the magnitude of fluctuations in the value of an investment on a daily or weekly basis.



The diagram above is a simple illustration of the risk and reward trade-off. Investment A offers lower expected return with lower risk compared to investment B which offers higher expected return with higher risk. It must be emphasised that the return and risk relationship may not be static over the short term, ie returns can fluctuate on a daily basis to varying degrees.

All investments, or asset classes, have different levels of risk and therefore different expected returns. It is important for the investor to understand that although an investment might be high risk and therefore offer the potential of a high return, it can also lead to a capital loss. Likewise a low risk investment, like cash, will not deliver the type of returns that might be needed by an investor over the long term but it would be highly unlikely to result in the loss of the investor's capital.

### **The Importance of Diversification**

One of the most effective means of reducing the different types of risk is to diversify your portfolio.

You can reduce the volatility by ensuring that it is not totally exposed to any one type of investment or investment approach.

No one type of security, asset class, investment strategy, or investment manager provides the best performance over all time periods. So a range of investments should reduce the risk of the portfolio experiencing drops in performance across the board, at the same time. This is simply because one asset class or manager may perform well to counter the poor performance of another.

Diversification can be implemented in two distinct ways:

- **Diversification Across Asset Classes**

The major asset classes – shares, private markets, property, bonds and cash – perform differently under different market conditions. Historically, no single asset class has consistently outperformed all others every year. So by investing across a variety of asset classes you may be able to reduce the volatility of your portfolio return.

- **Diversification Across Markets and Regions**

It is also valuable to spread your exposure within each asset class across a wide range of countries, currencies, industries and stocks. This global approach ensures that your investment is not narrowly concentrated in a particular region or industry, and helps to reduce the impact of a regional or industry downturn.