Understanding investment risk

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Investing involves risks. Risk that something happens so the investment outcome is not what was needed. This might lead to the loss of savings and therefore the need to save more or forego expenditure. Even if you invest in the 'safety' of a bank deposit, you are exposed to risk.

The presence of risk does not mean that a 'bad' thing will happen; just that it could. Each year, there is a range of things that might happen, but of these only a few will actually happen. The challenge is to understand what could go wrong (the risks you face) and which of these risks, if they occur, could be disastrous. By being aware of the potential consequences, you are in a better position to identify and manage those that are important risks. It is normally better to decide how you will do this in advance and not when the adverse event(s) happen.

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

The investment process

Investing is a process that starts with an investor's financial position, documents their goals and puts in place a plan to achieve them. The plan will involve a future savings level, an investment strategy, a series of timeframes, an approach to investing and a risk management policy.

For a given financial goal, there is a link between the required savings level and the investment return. The higher the investment return, the lower the required savings level and vice-versa.

The investment return is driven by the investment strategy (mix of cash, bonds, property and shares) and what happens in the markets. The appropriate investment strategy is the mix of cash, bonds, property and shares that is expected to provide the pattern of returns required, in terms of income and market movement (growth).

Investment returns, particularly over the short-term, are uncertain. The uncertainty creates the potential for something to occur that reduces the chances of achieving the goals. Part of the plan, therefore, is to manage the consequences of the uncertainty and monitor the progress towards the goals.

What is risk

Investment risk is the potential for things to happen that mean the returns are not as expected and as a result you do not achieve your goals. The 'things' might stem from interest rate changes, economic downturns, higher inflation, a drop in investor confidence, a change in government policy, a pandemic etc. As a result, it might mean that you do not get back some or all of your money when you expected, or you do not get as much natural income (eg interest, coupons, rent, dividends, distributions) as you thought, or you might lose your purchasing power through inflation so you cannot buy as much. It may also mean that the overall investment experience is unsettling.

Understanding consequences

In most cases the potential events that are reasonable to expect and would lead to adverse consequences, do not happen. But it is important to understand the negative consequences these different events could have on your investments if they did. If the potential consequence is unacceptable, the risk must be managed and in some cases avoided. Unmanaged risks present barriers to achieving financial goals and ultimately may result in needing to save more or spend less.

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

- A low or negative return for a period (a temporary loss), that gives you cause for concern.
- Earning less than expected or could have earned elsewhere and so being required to save more to achieve the goals.
- Having to sell an investment when the market is down so a loss that is a temporary loss, becomes a permanent loss.

- Earning less than the rate of inflation rate, so your buying power reduces.

And the consequences of these may be made worse by:

- Picking a poor financial adviser or investment manager.
- Using an investment manager with a particular style, ie how they make decisions, that proves inappropriate for the environment.
- Concentrating the investments in a few assets or a single active manager and not monitoring them closely.
- Having leverage in the portfolio (ie borrowing to invest).
- Paying high fees.

Illiquidity is the important risk short-term

If you need to spend money in the immediate future (next three years), illiquidity and volatility are important risks. To the extent that the expenditure will not be met by the income that the investments produce from interest, coupons, maturity proceeds, rent, dividends and distributions, an asset will need to be sold to make up the short fall. Because of the risk that a bond or share could decrease in value, it is best to maintain a level of liquidity (ie cash) so there is minimal risk (ideally none) that you have to sell an investment at a loss to meet the immediate expenditure. For this purpose, it is important to understand the difference between marketability and liquidity. An asset is marketable, if it can be readily converted to cash. An asset is liquid, if it can be converted to cash without suffering a loss. Most shares and bonds are marketable as they can be sold but because of daily fluctuations in their price, selling them may result in the realisation of a loss if the markets decline between the time the decision is made and the decision is implemented.

Inflation is often the important risk long-term

Many investors focus on the risk that the value of their savings go down (ie $100 becomes $90). This is important, if the $100 is to be spent next year but is easily mitigated through appropriate liquidity. Over the long-term a key risk is the consequences of inflation, ie what you thought you could buy for $100 costs $149 in 20 years at 2% a year inflation.

Inflation is a measure of the level that the prices of goods and services increase by over time. The consequence of rising prices is to reduce your buying power. While your money may not go down in absolute terms ($100 is still $100), if you can buy fewer goods and services, it goes down in real terms. For example, if you put $1,000 under your mattress today, in 10 years' time with inflation of 2% a year, it would buy only the same level of goods as $820 would today.

It is important to allow for the potential of inflation and its impact on your spending when working out how much money you'll need in the future and how you will invest your money for the long-term expenditure.

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

Inflation (% pa)	Value of $1,000
0.0%	$1,000
2.0%	$820
4.0%	$675
6.0%	$558
8.0%	$463

Time horizon is important

Your investment horizon is fundamental to the risk/reward trade-off. The longer your investment horizon, the more short-term uncertainty you can expose yourself to. in the pursuit of higher average returns. Over the long-term, however, you are never guaranteed, to get a higher return and the 'long-term' may require 30 to 40 years for the return advantage to emerge. If higher returns were guaranteed over shorter periods, there would not be any risk or return advantage.

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

You should also consider your willingness to take on risk.

Willingness to take on risk

It is important to take on the right level of risk for your needs and your investment personality. Taking on more risk than is needed, can be as bad as not taking on enough. Both can result in insufficient wealth and therefore require a higher savings level.

Your attitude to risk and willingness to take on risk, helps determine the type of investments you will choose to invest in and the amount of capital you will allocate to each. There are a number of factors that will affect your attitude to risk:

- The value of your current assets relative to the level required to achieve your goals. This indicates how much risk you can be exposed to without comprising the achievement of the ultimate goals. Sometimes this is referred to as your "funding level".
- Your level of secure or "safe" investments. If some of your total assets are part of a safety buffer, riskier long-term investments can be added to the portfolio without long-term adverse consequences from short-term events. This reflects the liquidity level of the investments relative to your immediate needs.
- Your current income and future earning capacity – generally, the higher your income, the greater your ability to cope with the consequences of risks and respond to events.
- Your age and "investment horizon" – a longer investment period often means you have time to recover from short-term market downturns. The issue is then one of whether you want to take on the risk.
- Your past investment experience and in particular, the impact of any losses suffered.
- Your personality – if your personality leads you to worry whatever the circumstances, a low-risk investment strategy may be the best.
- Your partner's view, if your investments are part of a wider family plan. The views of each partner are equally important.

But some risks, eg inflation, cannot be avoided. While the short-term ups and downs of the share market are often the main concern, as they can lead to a low average absolute return, for many, inflation is the key risk when determining a long-term investment plan and not being able to build up the wealth required to provide the required future income for your expenditure.

Choosing the right level of risk involves understanding the theoretical level of risk best suited to achieve your goals (the **risk tolerance**) and your willingness to take more or less risk than is theoretically right, ie your attitude to risk (or **risk preference**). Together these form your risk profile.

Risk profile = risk tolerance + risk preference