Thinking about tomorrow, today.

And today you are:

Understanding Investment Risk.

Understanding Investment Risk

This document will help you to understand the realities of investment risk through a balanced approach. It will also help you to distinguish the difference between risk and volatility.

And as an effective mechanism for risk management, it will also outline investment diversification and portfolio re-balancing.

The Question of Risk

The Oxford English Dictionary defines risk as "the possibility of loss, injury, or other adverse or unwelcome circumstance; a chance or situation involving such a possibility." The Australian Securities Exchange (ASX) defines risk as "the chance or a probability that an investment will result in a loss. This can also be referred to as the level of volatility returns attached to a particular investment."

With this in mind; it is a generally held view that the higher the potential rate of return, the higher the risk. But that can also relate to the amount of volatility you are prepared to endure. So, the risk/reward trade-off refers to the amount of risk (or volatility) that you are prepared to take to derive a higher rate of return.

Applying Common Sense to Risk

Any investment decision entails some degree of risk. Even bank deposits have a degree of risk relative to the credit worthiness of the bank, particularly in respect to the broader interest rate market impacting capital value.

When it comes to real estate, Australia's love affair tends to reduce the perceived risk. This is most likely due to the nature of the asset and the tendency to hold it for the long-term. The fact is that real estate has a history of volatile fluctuations in value.

Australian shares are considered by many to be high risk. This is because price volatility can be seen on a daily basis and does not necessarily relate to capital loss if the investments are held for the long term.

In reality, the risk of capital loss relates to the individual investment asset and its intrinsic value. That is, if the intrinsic asset value is substantiated by sustainable earnings and assets, the risk of capital loss is low. If the intrinsic asset value is based on future perceived earnings, then the risk of capital loss is high. The latter is termed speculation and is a high-risk strategy.

When evaluating investment selection, it is important to distinguish between market volatility and the risk of capital loss.

Types of Risk

When understanding risk, it's more than just the possibility of a bad investment. There are many other factors that need to be taken into account.

This table provides a summary of the types of risk you may encounter.

RISK TYPE	WHAT IT MEANS
1. MISMATCH RISK	The investment you choose may not suit your needs and circumstances
2. INFLATION RISK	That the purchasing power of your money will be eroded by inflation
3. INTEREST RATE RISK	That changing interest rates will reduce your returns or cause you to lose your money
4. MARKET RISK	That movements in investment markets may impact the value of your individual investments
5. DIVERSIFICATION RISK	The over-exposure to any one investment or investment market
6. CURRENCY RISK	That currency movements will affect your investments
7. LIQUIDITY RISK	The risk that you can't access your money when you need it
8. CREDIT RISK	That the institution you invest with may not be able to meet its obligations (i.e. default on interest payments)
9. LEGISLATIVE RISK	Risk due to changes in laws and regulations
10. GEARING RISK	The added risk involved when borrowing to invest

Mismatch Risk

Investments have different characteristics including the types of return they generate (for example, income and/or capital growth) and the time frames

required to achieve them. By their nature, some investments need to be held for longer periods to provide sufficient time for them to achieve their potential. Likewise, other investments produce immediate returns but may need to be reviewed more regularly.

It is important to choose investments with the characteristics that align with your objectives. This will ensure there's no mismatch and will enhance the likelihood of achieving the outcomes you seek.

Generally speaking, investment assets that are purely income oriented – such as bank accounts and term deposits – are short term in nature. Investments that have a capital growth potential, such as shares or property, are generally longer term in nature. Short term investment in these assets is considered to be speculation and high risk. A way to help you avoid mismatch risk is to align your time frame, objectives and investments as per the following table:

OBJECTIVE	TIME FRAME	INVESTMENT
SHORT TERM: Immediate income, capital expenditure e.g. holiday	**12 -24 MONTHS; ONGOING INCOME**	Cash fixed interests
MEDIUM TERM: e.g. home deposit, capital expenditure e.g. new car	**AT LEAST 3 YEARS**	Cash, fixed interest and growth assets with strong income dividends
LONG TERM: e.g. School fees, retirement	**MORE THAN 5 YEARS**	Emphasis on growth assets (shares and property) with access to cash

Multi-Generational Wealth Transfer

An important consideration in the objective based equation is estate planning and multi-generational wealth transfer.

In circumstances where you might wish to leave assets to the beneficiaries of your estate, there is an impact on the overall objectives of your strategy and plan. In this case, there is a dual objective: shorter term reliable income with access to capital and longer-term capital growth. This requires careful consideration and planning.

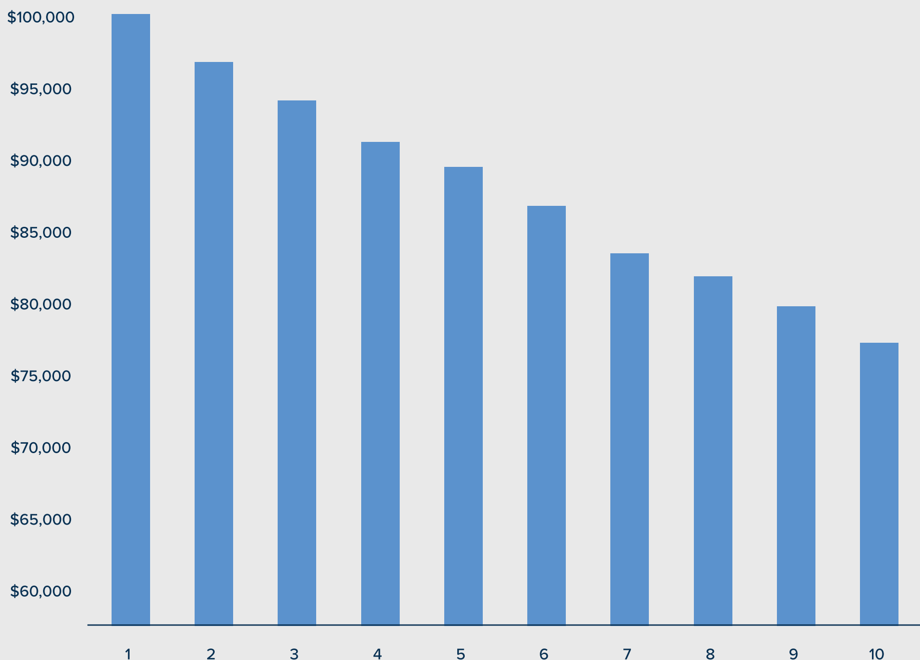
Inflation Risk

Inflation is a silent enemy when it comes to investment planning. It represents an increase in the price we pay for goods and services or the purchasing power of capital. If the rate of inflation remained at 3% per year, $100 today would only purchase the equivalent of $74 in 10 years' time.

Put in investment terms, a term deposit earning 2% today would need to earn the equivalent of 5% in 10 years' time to produce the same purchasing power.

Where investment interest is fully utilised for income purposes, the value of capital will reduce in real terms by the rate of inflation. In the long term, this can be disastrous and the reason why some growth investments are usually essential.

The following chart illustrates the effect of inflation on the "real" value of $100,000 invested over 10 years:



Case Study

Jane is a 68-year-old self-funded retiree who relies on her investments for income, In 2013 when she retired, Jane calculated her cost of living to be around $60,000 per annum and invested $1,000,000 in fixed interest term deposit investments with an average income return of 6%, which covered her income needs.

In 2018, Jane came to reinvest her capital but found that her cost of living had increased to $69,550 (3% inflation per year) and the available interest rate had fallen to 4% per annum, This meant that Jane's $1,000,000 term deposit investment would earn only $40,000 or $29,550 short of Jane's income needs. It is estimated that Jane's capital will have diminished by 14% to around $858,734 by the end of 2018 with an income need of around $69,500 per annum.

Because there was no capital growth applicable to Jane's investment, this strategy will result in the increasing erosion of her investment capital.

Market Risk

Market risk relates to the fluctuating value of investments due to changes in broad market conditions rather than the fundamental value of individual investments.

Markets can be subject to value fluctuations caused by a variety of influences including economic conditions and extraordinary events. Some examples in recent times are the Iraq Wars, 9/11, the Global Financial Crisis (GFC), and the current US/China trade wars.

When markets fluctuate, it does not necessarily alter the true intrinsic value of an investment or its ability to generate dividend earnings.

When these violent fluctuations occur, the emotive facts, fear and greed tend to

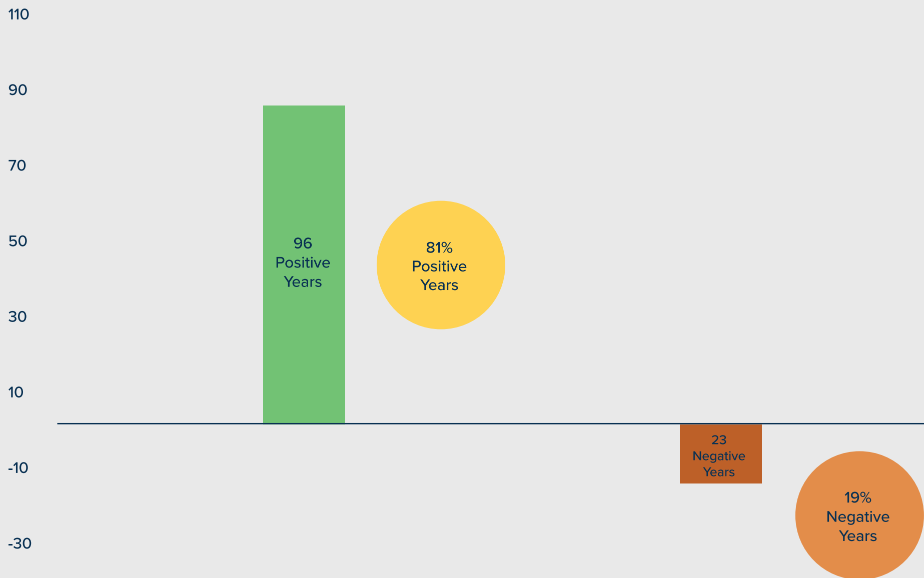
take over and investors react accordingly. When markets fall fear can set in and investors panic and sell. And greed emerges when markets climb and investors buy.

Cool-headed logic says that investors should aim to buy at the bottom of the market when prices are cheap and sell at the top of the market when investments are expensive. Emotions, however, usually drive investors to make illogical decisions to sell when the market falls and buy when it is on the rise.

> *"Be fearful when others are greedy and greedy when others are fearful."*
>
> – WARREN BUFFET

Australian Share market – 119 years of historical returns

Since 1900, the Australian Share market has returned an average 13.1% per annum.



*Past performance is not a reliable indicator of future performance.

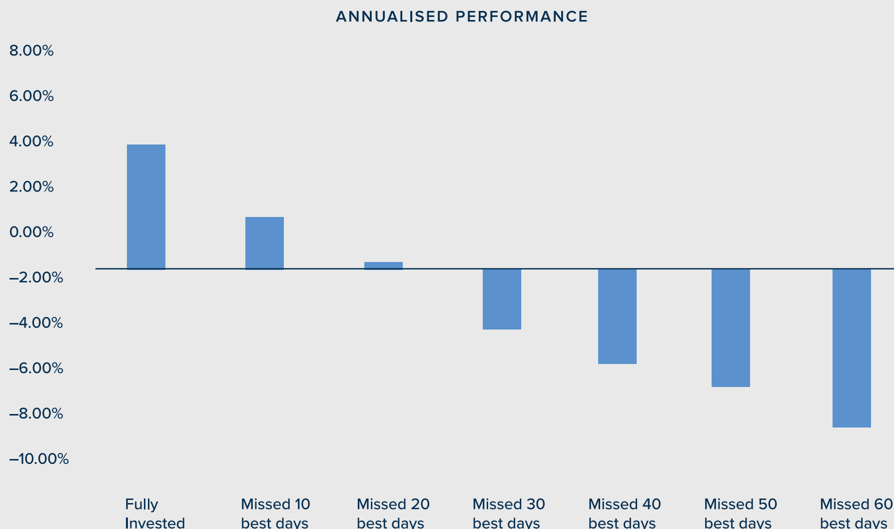
“Timing the Market” VS “Time in the Market”

When investment markets fall, investors often adopt the view to sell out with the aim to re-purchase investments when the market improves. This is called “timing the market” or endeavouring to sell high or buy low. The problem with this theory is getting the timing right and knowing when to sell and when to buy. The problem is that virtually no-one can accurately anticipate a market fall and likewise, timing a re-entry into the market before a recovery is almost impossible.

The opposite view to timing the market is “time in the market” or taking a longer-term view. This focus is based on a philosophy of buying and holding quality assets for the longer term and ignoring short term market fluctuations. History has shown that time in the market is a far more effective strategy than attempting to time the market. Portfolio diversification and re-balancing are important contributing factors we will cover later in this booklet.

Missing the Best Days Erodes Returns

Looking back over the 20-year period from January 1, 1999, to December 31, 2018, if you missed the top 10 best days in the stock market, your overall return was cut in half. J.P. Morgan Asset Management's 2019 Retirement Guide shows the impact that pulling out of the market has on a portfolio.



> *"If you missed the top 10 best days in the stock market, your overall return was cut in half."**

If you were fully invested in the S&P 500, your annualised total return was 7.7% during that time. But if you missed the 10 best days in the market, it dropped to 2.65%.

*Period for Jan 1 1991 – Dec 31 2018. Past performance is not a reliable indicator of future performance.

Investment Spread – Diversification of Risk

The proverb "Don't put all your eggs in one basket" paraphrases the issue of diversification risk. Investment consists of different asset classes, each with different characteristics and performance cycles. Whilst it is wise to diversify across different asset classes and within those classes themselves, the overall strategic objectives of the investment portfolio should not be structured purely for the sake of diversification.

Studies have proven that diversification of investments reduces volatility risk, as different asset classes perform at different stages of the economic cycle.

Objective Based Asset Allocation Strategy

Asset allocation or investment mix is often determined by risk profiling. That is, the exposure to each asset class is determined by the clients' supposed attitude to risk, which has been based on a series of questions relating to investment risk. This will typically classify the client as a client type e.g. a "Balanced Investor" and asset allocation will be dictated accordingly.

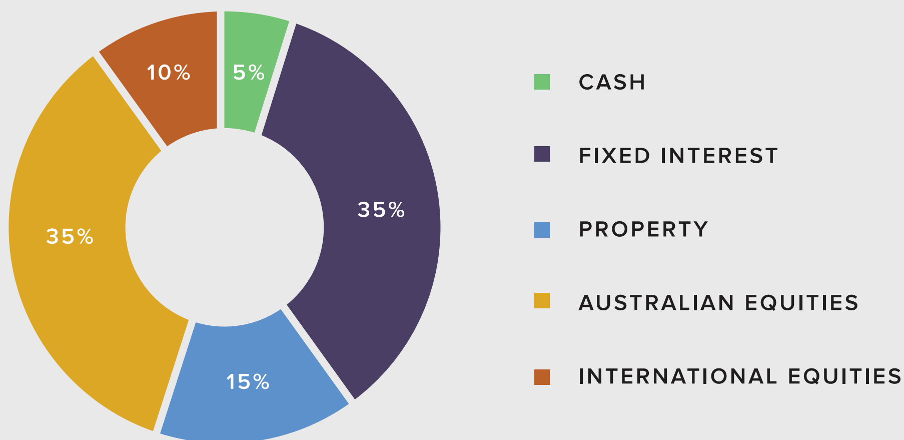
We are firmly of the view that asset allocation and the selection of investments within each asset class should be chosen based on achieving a client's financial objectives. Each asset class has different performance characteristics as do investments within those asset classes, and it is the balance of these characteristics that determine the achievement of client outcomes.

Disciplined portfolio re-balancing is essential to the maintenance of the integrity of the investment or asset allocation strategy. This is to maintain the balance of growth and income attributes of the portfolio and maintain the balance of risk exposure.

Once the investment strategy has been designed and the asset allocation has been determined, it is our responsibility to explain the strategy to clients and the details of the underlying investments together with issues of risk and volatility. It is then that client's need to determine their attitude to the issues of risk and volatility.

Asset Allocation Example

ASSET CLASS	$	%
CASH	$70,000	5%
FIXED INTEREST	$490,000	35%
PROPERTY	$210,000	15%
AUSTRALIAN EQUITIES	$490,000	35%
INTERNATIONAL EQUITIES	$140,000	10%
TOTAL	$1,400,000	100%



Asset Classes and Their Characteristics

A brief description of each of the major investment assets classes follows:

Fixed and Variable Interest Securities

These are "debt securities". That is, they are effectively loans to other parties who pay interest to you as the lender. They do not usually provide any capital growth potential, so you must factor in the impact of inflation to the real value of capital.

Debt securities will usually return the capital invested upon maturity. That is, the end of the loan period. As a risk management tool, this is important to diversify the volatility of other investment assets.

Whilst debt instruments return capital to the investor, they nevertheless are subject to market fluctuations brought about by changing interest rates. In the case of a fixed interest security like a government bond or a term deposit, when interest rates rise, the effective market value of the security falls. Of course, this is not readily evident unless you are forced to redeem the investment before its maturity date.

Characteristics

Income	Reliable and quantifiable
Growth Potential	Nil
Security	High (generally speaking)
Volatility	Low

Australian Shares

These are equity investments where the holder owns a share of a publicly listed company. They are essentially a long-term investment and should not be considered for time periods less than a minimum of 5 years.

Australian shares can provide attractive rates of dividend income in the short term and the potential for capital growth in the longer term. Share markets can

be volatile, and it is generally accepted that investors will experience a negative growth return on an average of one year in seven.

The capital growth potential of this asset class provides an important hedge against inflation in respect to the value of the capital itself and its ability to generate increasing levels of income to keep pace with the rising cost of living. Dividends paid by Australian company shares will generally grow as the company's earnings increase. This is an important factor when evaluating share investment.

Characteristics:

Income	Reliable and quantifiable (generally speaking)
Growth Potential	Good
Security	Depends on the company
Volatility	Comparatively high

International shares are similar in character to Australian shares except for some distinguishing issues. By comparison they tend to pay less income and are usually accessed via a managed vehicle or an Exchange Traded Fund. So, in essence, international shares are more of an investment in pure capital growth potential.

International share investments are subject to share market volatility. They are a long-term investment and should not be considered for periods less than five years minimum.

Characteristics:

Income	Low and not quantifiable
Growth Potential	Good
Security	Generally good (depending upon the company)
Volatility	Comparatively high

Property

Property investment may consist of residential, commercial/office or industrial property, which can be accessed via direct ownership, unit trust ownership or via ASX listed unit trust. Real estate is essentially a growth-oriented investment although some commercial or industrial property can produce reasonable rates of rental income. Generally speaking, higher rental returns equate to lower growth potential, but careful research needs to be undertaken.

There are usually costs associated with real estate investment such as stamp duty, management and maintenance, all of which need to be taken into account in the evaluation process. Real estate is a long-term investment and should not be considered for periods of less than 7 years.

Characteristics:

Income	Low to moderate
Growth Potential	Good
Security	Generally good (depending upon the company)
Volatility	Moderate

Currency Risk

Currency risk refers to investments, which reside outside of Australia and could include foreign shares, foreign property or foreign bonds. Apart from the performance of these assets, in their own right, they are susceptible to fluctuations in value due to variations in the value of the Australian dollar relative to the currency of the country in which they are invested.

For example, if an investment of $AU was made in assets denominated in $US when the value of each were the same, an increase in the value of the $AU would result in a fall in the value of the asset. To explain further, as the asset is priced in $US, if the value of converting $US to $AU falls, that is you receive less $US than $AU, the sale value of the asset falls.

Hedging Currency Risk

Currency risk can be controlled by fund managers to some extent through "hedging." The hedging process is complex. Put simply, it is managing the value of foreign assets from currency fluctuation. Managed fund structures may be chosen as either unhedged or hedged. It should be noted that hedging currency has a cost.

Legislative Risk

When designing a financial planning strategy, you rely on the laws and the regulations in place at the time. There is always a risk that the rules could change as we have seen with superannuation and taxation over the years with various governments. Therefore, it is important that your structure and strategy has the flexibility to adapt to change as it occurs over time.

Gearing Investment

Gearing or leveraging of investment is where investors borrow to invest in order to increase the rate of return. Gearing is usually used for investment in shares or real estate, being growth-oriented assets.

The following table illustrates an example of the impact that gearing can have on the rate of return.

	UNGEARED	GEARED
CAPITAL INVESTED	$50,000	$50,000
BORROWED FUNDS	$ -	$50,000
TOTAL INVESTED	$50,000	$100,000
CAPITAL GROWTH @10%	$5,000	$10,000
RATE OF RETURN ON CAPITAL INVESTED	10%	20%

As indicated from this simple illustration, the doubling of the total amount invested using borrowed funds doubled the rate of return on the capital.

It must be noted that gearing works in the negative as well as the positive. So, using our example, if the rate of return was -10%, the rate of loss on the capital invested would be -20%.

The Question of Cash Flow

The following table illustrates the cash flow that could apply to our example above:

	UNGEARED	GEARED
DIVIDEND INCOME @ 5%	$2,500	$5,000
LESS INTEREST @ 6.5%	$ -	$6,500
CASH FLOW	$2,500	(- $1,500)

As indicated in this table, the geared investment is ‘negatively geared’, which means the interest outlay is higher than the investment income. Whilst a tax deduction can be obtained for the loss amount, it nevertheless results in a cash flow loss that must be recovered from the capital gain of the investment when sold.

There is also the risk in the funding of the surplus interest amount in the event of a loss of income from other sources e.g. employment.

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It’s about today.

And today Hewison
Private Wealth is here.

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