The trade-off

Understanding investment risk

FPA
FINANCIAL PLANNING ASSOCIATION OF AUSTRALIA

“Risk is not knowing what you are doing.”
Warren Buffett

Contents

Foreword	1
Need to know, afraid to ask? Why you need to understand risk	3
Types of risk	4
Tug of war: Mismatch risk	5
Bubble trouble: Inflation risk	7
A not-so-great rate? Interest rate risk	9
‘Bazaar’ behaviour: Market risk	11
Of time and timing: The risks of market timing	13
Eggs and baskets: The importance of diversification	18
Flight risk: Managing currency risk	20
Rainy-day money: Liquidity risk	21
Trust issues: Credit risk	23
Changing rules: Legislative risk	24
Doubling up: Gearing risk	25
Different assets, different risks	26
A suitable choice	27
And now what?	28

Foreword

We take risks every day. Most of the time we don't give it a second thought – it's only when something goes wrong that we're reminded that risk was there all along.

Our society is built on an ability to identify, measure and exploit risk. This ability helps us construct cities, reduce the number of road deaths, create wealth and protect the least fortunate amongst us – and a vast array of other things as well. But we're all too often reminded of what happens when risk reasserts itself.

Investors in Westpoint, Bridgecorp, Fincorp and Basis Capital didn't necessarily perceive their investments as risky (because in some cases they were advertised as "safe" – but that's another story). We can see clearly now that there were risks – and that the risks were always there.

In one of the best books ever written about the subject, *Against The Gods: The remarkable story of risk*, Peter Bernstein, an economist and founding editor of the *Journal of Portfolio Management*, says the boundary between what might be described as "modern times" and "the past" is man's ability to master risk.

As soon as mankind realised that what happens in the future is not a mere whim of the gods – that it was possible to look into the future and choose a path to follow – the world changed forever, he says.

The ability to identify, measure and exploit risk is critical to successful investing. Risk never goes away, but sometimes it's easy to forget it's there. Even when markets are performing strongly, and everything we touch seems to turn to gold, risk is the investor's constant companion. Risk is what enables us to earn an investment return, but it's also the force that can bring everything undone. There's a mountain of academic literature that explains how and why risk works both for and against us.

Bernstein says that almost all of the tools investors use today to manage risk – from game theory to chaos theory – stem from work carried out by philosophers, mathematicians and other intellectuals between 1654 and 1760.

He says there are two clear exceptions: in 1875 the idea of "reversion to the mean" was first expounded. And in 1952 it was demonstrated beyond doubt that diversification is the nearest thing an investor can ever get to a "free lunch".

Foreword

Both of those discoveries continue to have fundamental and far-reaching consequences for investors.

There are some simple rules that all investors should never forget. You cannot earn an investment return without taking a risk with your money. But you can't just go on taking more and more risk and expect to get bigger and bigger returns – eventually the link between the two will snap, and then you're in trouble. And while you can take steps to minimise risk, you can never eliminate it.

Before you can minimise risk, however, you have to know what you're facing. The Financial Planning Association of Australia is to be congratulated on producing this booklet, which serves as an excellent introduction to the subject for all investors.

Simon Hoyle
Editor and senior finance journalist

January 2008

Need to know, afraid to ask?

Why you need to understand risk

There are a number of ways of looking at risk depending on whose perspective is being taken into account.

The chance of loss

The Cambridge dictionary defines 'risk' with elegant simplicity as "the possibility of something bad happening." From the perspective of an investor, 'risk' may be defined by asking "What are the chances of losing my money?" Neither definition is exactly correct in an investment sense. However they may represent your own definition of risk – and that's just as important.

Variability and volatility

From another perspective closer to that of investment professionals and fund managers, 'risk' can be defined as "the variability of returns." In this case 'risk' is seen as the difference between expectations and results.

A common sense definition

Generally, 'risk' can be the price you pay for returns. Just as the more work you do, the more you should be paid, so the more risk you take, the higher the return you should receive. This is the 'risk/reward trade-off'. It is one of the key concepts of investment – and one we shall apply throughout this booklet.

Any investment decision implies some 'risk'. This booklet outlines many of the risks you should be aware of when making an investment. With a better understanding, you can make a more informed investment decision – accepting some risks and rejecting others. In other words, you can manage risk.

Types of risk

This table highlights some of the risks you could encounter when making an investment.

Risk type	What it means
Mismatch risk	The investment opportunity may not suit your needs and circumstances.
Inflation risk	The risk that the purchasing power of your money may be eroded by inflation.
Interest rate risk	The risk of changing interest rates that may reduce your returns or cause you to lose money.
Market risk	The risk of movements in asset markets (share markets, bond markets, etc.) reducing the value of your investment or returns.
Market timing risk	The timing of your investment decision exposing you to the risk of lower returns or capital loss.
Risk of poor diversification	The poor performance of a small number of asset classes can significantly affect your total portfolio.
Currency risk	The risk that currency movements can affect your investment.
Liquidity risk	The risk of not being able to access your money quickly or cheaply when you choose to.
Credit risk	The risk that the institution you invest with may not meet its obligations (i.e. default on interest payments).
Legislative risk	The risk of losing your capital or suffering reduced returns due to changes in laws and regulations.
Gearing risk	The risk involved in borrowing to invest.

Tug of war

Mismatch risk

Investors often find that together with patience, skill and good advice an investment plan often assists them in deciding what they want their investments to achieve.

By adhering to a plan, you can avoid the temptation of investing emotionally or on a whim. You may feel more secure in investing in a conservative investment or feel more excited by investing in the next 'hot stock'. It's harder to invest rationally – ignoring your feelings to make sure the investments you choose achieve your goals. You do that by focusing on your objectives and time frame.

Your objectives

To help decide what your investment objectives are, ask yourself the following questions:

- What are you seeking to achieve by investing?
  - To save a deposit for a home?
  - Pay for the education of your children?
  - Fund your retirement?
- Are you investing for income, capital growth or a combination of the two?

You need to choose investments that will help you achieve those goals.

Your time frame

Sometimes you will have a specific goal and invest for a short time only. At other times you may want to take a long-term view, aiming to grow your capital (e.g. in preparing for retirement). One way to help you avoid mismatch risk is to match your time frame, objectives and investments – as in the following table.

Objective	Time frame	Investment
Short-term (e.g. a holiday, appliance purchase)	Less than 12 months	Cash, short-term deposits and money market securities
Medium-term (e.g. a home deposit)	At least three years	Emphasis on fixed interest with some cash, longer-term deposits and growth assets
Long-term (e.g. children’s education, retirement)	More than five years	Emphasis on growth assets (shares and property) with some access to cash

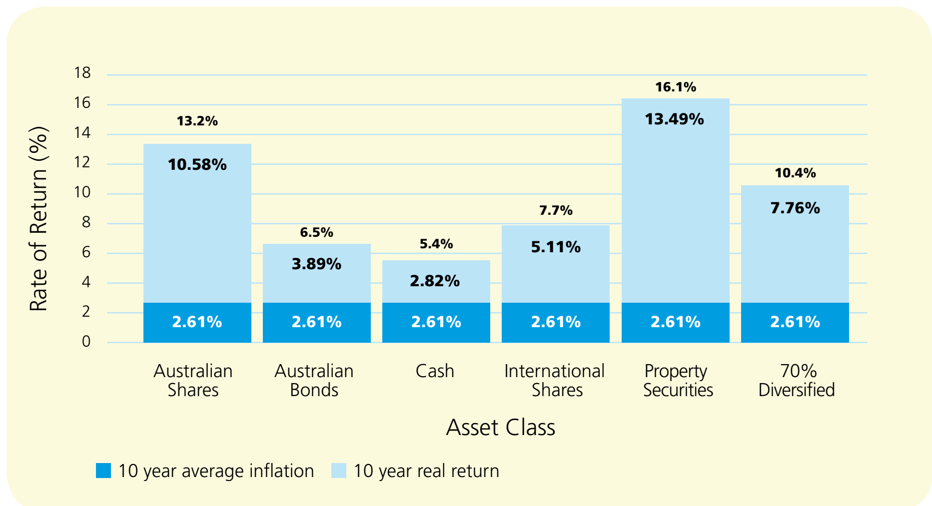
Bubble trouble

Inflation risk

Inflation is an increase in the price we pay for goods and services. Because of inflation, $1.00 today will buy you more now than it will at some point in the future. Even if the rate of inflation remained at a relatively low 3% p.a., a $1.00 purchase will cost $1.56 in 15 years' time.

Inflation is investors' great enemy. It eats away at your returns, pushes up interest rates and, if excessive, can lead to poor investment decisions.

The graph below shows the rate of return of different asset classes over a ten year period. As shown, inflation over this period can reduce the purchasing power of your income by significant amounts.



Graph prepared by Russell Investment Management Ltd from data sourced from RBA; ASX.

The rates of return are averaged from 1996 – 2006.

When deciding on the return you want from your investments – and therefore what investment strategy to pursue – it is vital you take the effect of inflation into account. If the after-tax return is less than the rate of inflation, the real value of your money will decline.

To help protect your investments from inflation over time you need some capital growth. While fixed term deposits and savings accounts may generate a regular income, your capital value remains the same. Many people choose these investments because they seem safer. However, if they do not keep pace with inflation they can lose money!

That's why most medium to long-term investment strategies include at least some growth investments like shares and property. They have a better chance of beating inflation than cash or fixed income investments.

This is particularly important for retirement investing. Many retirees focus on 'protecting' their capital. Yet longer life expectancy and the effects of inflation mean retirees can easily outlive their capital if they do not use growth assets to boost the value of their portfolio over time.

It's the return after inflation that really counts

Inflation causes money to lose value, it means your money will not buy the same amount in the future as it does now, or has in the past. When you are deciding on your long-term investment strategy, ensure you look at an investment's real rate of return, which is the return after inflation.

A not-so-great rate?

Interest rate risk

"The policy of being too cautious is the greatest risk of all."

Jawaharlal Nehru
(1889 – 1964)

Fixed income investments are highly attractive to investors whose main priorities are income and security. Many fixed interest investments invest in government bonds. They offer excellent security because a government (Australian or foreign) guarantees to repay the capital value when the bonds mature. However, fixed interest investments do have their own risks.

Quality risk

Firstly, all bonds are not equal. The bonds issued by a government like Australia, the US, France or Japan are considered much more secure than those offered by countries with weak economies or those suffering political instability. Bonds from a government like that in Zimbabwe, which has recently had political, economical and social unrest, would generally pay higher rates than bonds from more stable economies. That's the 'risk/reward trade-off' again.

Not all bonds are government bonds. Semi-government bodies like water boards or electricity utilities can issue bonds. Once again you will generally find that bonds from high quality organisations pay a lower rate of return since there is a much lower level of risk involved.

Reinvestment risk

Interest rates go up and down depending on the economic climate. If you're invested in bonds and there is a drop in interest rates, you may be forced to reinvest at a lower rate (and receive less income) when your investment matures.

Because fixed rate investments generate no capital growth, there's no extra capital available to bolster your income.

Capital risk

Fixed interest investments such as bonds generally pay a fixed income (known as the 'coupon payment') which is set on issue. However, it's important to remember that while the coupon payment (the regular income you receive) is fixed, movements in market interest rates can affect bond prices.

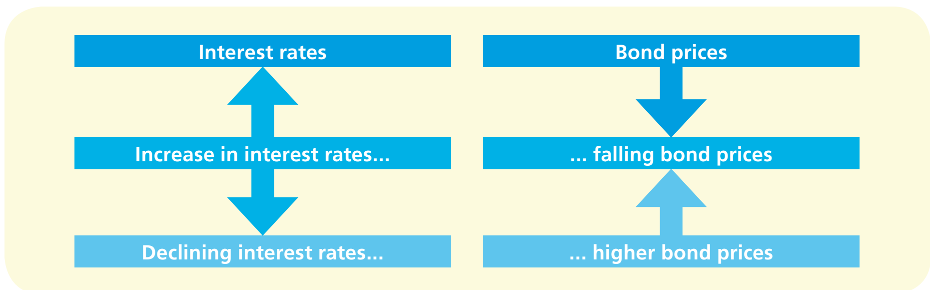
Typically, you can buy and sell bonds before their maturity date. Their price is affected by how attractive their coupon payment is at a given time.

The following diagram shows the inverse relationship between interest rates and bond prices – a rise in interest rates leads to a fall in bond prices and vice versa.

So if you need to sell your bond in an emergency, the price at which it sells will depend on the interest rate at the time.

If interest rates rise between the date of purchase and the date you sell it, you may have to sell the bond for less than you would have received if you waited until it matured. You may lose money.

Impact of movements in interest rates on bond prices



Consider this example. A five year bond worth $100,000[1] when interest rates are 5% p.a. would be worth approximately $96,000 if interest rates were to rise to 6% p.a. Fluctuating interest rates don't only affect your income, they can also affect your capital value if you need to sell the bond before its maturity.

This concept of capital risk is also applicable to bond funds – managed funds which buy, hold and trade a wide variety of bonds with the aim of generating better income returns. Bond funds are highly attractive to income investors – they can offer wider diversification, good flexibility, the potential for capital gain and professional management. Generally bond funds are more secure than share or property funds; however, they can suffer occasional capital losses if interest rates move against the expectations of the manager.

[1] *5% p.a. coupons payable half-yearly assumed.*

‘Bazaar’ behaviour

Market risk

“It will fluctuate.”

JP Morgan, founder of one of America’s first investment banks, when asked what the stock market will do.

The essence of a local fruit market is that prices there tend to change – if they didn’t you might never go to the local markets looking for a bargain. The same is true of prices in investment markets. Driven by supply and demand, prices must fluctuate – and that creates volatility.

At your local fruit market, you will notice that the price of some goods moves more than others. Different types of fruit move up and down in price with the seasons.

The same is true in investment markets. Different investments have different levels of volatility. Investments expected to generate higher long-term returns (such as shares) generally show greater volatility in the short-term.

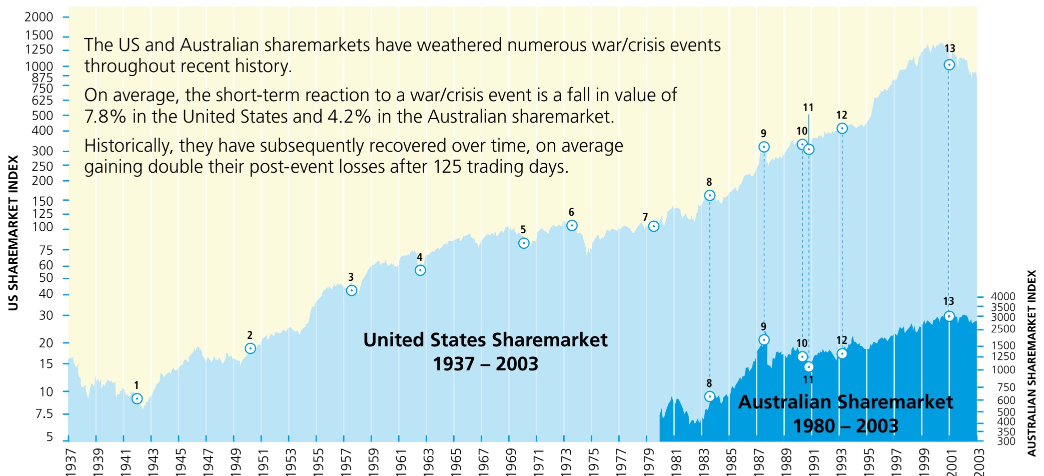
If you accept that the volatility is a characteristic of higher returning assets, it becomes a problem only if you don’t have the time to ride it out (see ‘Mismatch risk’, page five).

It’s important to remember that markets must go through ups and downs. It’s tempting to sell an investment if its value falls. However, history proves that having the discipline to stick with quality assets is generally a more successful strategy over time.

Research from the Australian Stock Exchange (ASX) bears this out. Between December 1980 and 2006, there were eight calendar years when the All Ordinaries Index (or its equivalent) generated a negative return. But the All Ordinaries is yet to produce a single negative ten-year return.

The graph and table below summarise historical reactions to wars and crises on the United States and Australian sharemarkets. While history is no prediction of the future; it is useful to reflect on the response and recovery of the sharemarket in similar times of pressure and uncertainty throughout the past 65 years. The long-term results all prove the value of staying the course through the market ups and downs.

Sharemarket reaction and recovery



1 Pearl Harbour	8 US invades Grenada
2 Korean War	9 1987 financial panic
3 Sputnik	10 Iraq invades Kuwait
4 Cuban Missile Crisis	11 Gulf War
5 US bombs Cambodia	12 World Trade Centre bombing
6 Arab oil embargo	13 September 11 Terrorist Attacks
7 USSR in Afghanistan	

Graph prepared by Russell Investment Management Ltd. This timeline charts the progress of the US sharemarket since 1937, and the Australian sharemarket since 1980. It plots some pre-1980 war/crisis events for the US sharemarket, and plots some post-1980 war/crisis events for both the US and Australian sharemarkets. Separate logarithmic vertical scales have been used to emphasise the proportionate importance of fluctuations for both sharemarkets. The numerical markers on the chart correspond to a war/crisis event listed in the above table. Each event is timeframed by a sharemarket 'reaction start' and 'reaction end' date. The 'reaction start' date indicates the trading day prior to the event or the start of the market reaction to that event. The 'reaction end' date refers to the market low experienced in the short-term following the event. The US sharemarket index used is the S&P500 (in USD). The Australian sharemarket index used is the All Ordinaries Index (in AUD).

Of time and timing

The risks of market timing

"Look at stocks as businesses. Look for businesses you understand, run by people you trust and are comfortable with, and leave them alone for a long time."

Warren Buffett

Many people believe investing is about 'timing the market' – getting in before prices rise, enjoying the ride up and then getting out before prices fall.

Anticipating these market movements can be extremely difficult because no two market cycles are the same. Investors' emotions make successful market timing even harder which makes sticking to your plan even more important. While logic suggests the best time to buy is when asset prices are cheap or falling, many investors tend to buy when prices are rising and sell when they are falling. The emotions of fear and greed can lead us to buy and sell at exactly the wrong times.

A lot of long-term research suggests that market timing is difficult, even for professionals. It's not just that expert advice helps you pick better investments; it's that it stops you chopping and changing.

As an investor, you must allow time for the rises and falls of the market to take their course. The main message from investment experts is that it is better to buy and hold rather than trying to time the market. As the cliché says "It's time; not timing that counts".

Time in the market, not timing the market

The graph over the page shows the result of investing $10,000 in the Australian sharemarket in February 1980 and pursuing a "buy and hold" strategy resulted in the original investment being worth $316,332 on July 31, 2007. The graph also shows the effects on the investment of missing the best performing months – the difference is quite substantial.

Calculations indicate that an investor who incorrectly attempted to time the market and missed the single best month *over a 27 year period* ended up with $272,313, *almost 14%* less than the investor who pursued the buy and hold strategy. Investors who sat on the sidelines and missed the best 10 months over a *27 year period* finished with just $102,948, *67% less* than the patient 'buy and hold' investor's end value.

As you can see, disciplined investing would have been a better investment strategy.

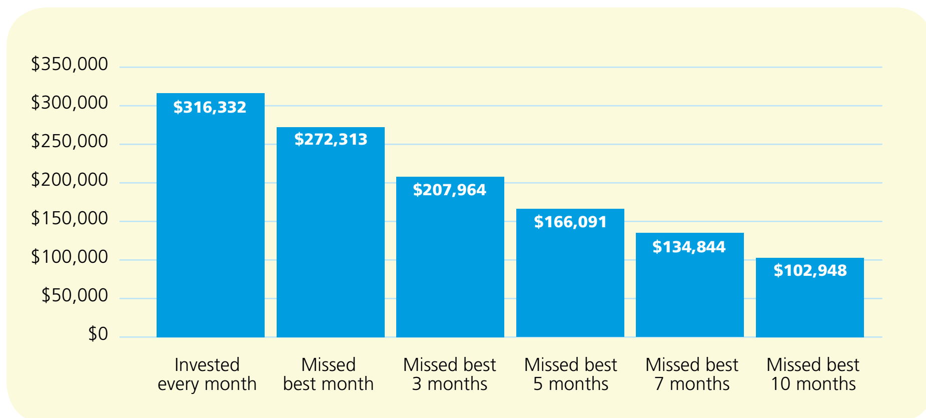
The price of trading

Investors who try to time the market often find that trading is expensive – and not just because of the added transaction costs. Research from Yale University[2] by academics Nicolosi, Peng and Zhu concluded –

> "investors trade excessively: investors who trade the most earn the lowest average returns after transaction costs. Interestingly, on average, men trade more actively yet perform worse than women. Investors who switch from phone-based trading to online trading also trade more and earn lower returns."

Market timing is expensive and risky – it means you have to get more decisions right – and that's hard to do.

Effect of missing best month(s) – Australia



Graph prepared by Russell Investment Management Ltd from data sourced from ASX. ASX All Ords Accum Index in AUD 29/2/80 to 31/7/07.

[2] *Source: Yale ICF Working Paper No. 03-32, November 2003. 'Do individual investors learn from their trading experience?'*

The lessons of history

The past is not necessarily an indication of future performance, however, history does have things to teach us. This table shows the yearly rate of return for various asset classes over the past 20 years. The blue shaded figures represent the best performing asset each year, while the yellow shaded figures represent the worst performing asset sector.

Historical returns from major asset sectors

End of year	Australian shares	International shares	Australian property	Fixed interest	Cash	Balanced
Dec-87	-8%	7%	6%	19%	15%	4%
Dec-88	18%	4%	16%	10%	13%	15%
Dec-89	17%	26%	2%	15%	18%	19%
Dec-90	-18%	-15%	9%	19%	16%	-4%
Dec-91	34%	20%	20%	25%	11%	25%
Dec-92	-2%	5%	7%	10%	7%	4%
Dec-93	45%	24%	30%	16%	5%	28%
Dec-94	-9%	-8%	-6%	-5%	5%	-6%
Dec-95	20%	26%	13%	19%	8%	20%
Dec-96	15%	6%	14%	12%	8%	12%
Dec-97	12%	42%	20%	12%	6%	19%
Dec-98	12%	32%	18%	10%	5%	16%
Dec-99	16%	17%	-5%	-1%	5%	11%
Dec-00	5%	2%	18%	12%	6%	6%
Dec-01	10%	-10%	15%	5%	5%	3%
Dec-02	-9%	-27%	12%	9%	5%	-7%
Dec-03	15%	-1%	9%	3%	5%	10%
Dec-04	28%	10%	32%	7%	6%	17%
Dec-05	23%	17%	13%	6%	6%	15%
Dec-06	25%	12%	34%	3%	6%	16%
Dec-07	16%	-2%	-8%	4%	7%	6%

Graph prepared by Russell Investment Management Ltd from data sourced from ASX; Bloomberg; RBA

Last year's winner?

The complex relationships between different asset types mean that if one asset class is doing well, another may be performing poorly. For example, if the government is raising interest rates to slow down the economy, the sharemarket usually weakens. Rising rates make it more expensive for companies to do business and therefore reduce profits. Yet higher interest rates are good news for cash investors.

It's tempting to try and ride these cycles – to switch your money into the latest 'hot' investment. This is rarely a wise strategy because of all sorts of factors – economics, politics, market sentiment and international events impact the markets. Proof that it's hard to make those judgments is illustrated in the table on the previous page – the best performing asset often changes from year to year. In other words, chasing last year's top asset is a risky strategy. A diversified portfolio can generate consistent long-term returns with less volatility than chasing last year's best returning assets.

Sticking with your strategy

Despite ups and downs, most assets have fared well over the long-term. The chart below shows the rate of return a hypothetical investor would have received from long-term investments in the major asset classes.

Rate of return on $10,000 if invested in December 1997

	Australian Shares	International Shares	Australian Property Securities	Cash	50% Diversified
10 Year Average	14.1%	5.1%	13.7%	5.5%	8.4%
10 Year Real Return	10.7%	1%	10.1%	2.6%	5.4%

Graph prepared by Russell Investment Management Ltd from data sourced from ASX; Bloomberg; RBA based on 10 year average inflation of 2.9%. Returns do not take into account fees.

Handling volatility

So how do you cope with the stresses that come with volatility?

1. Stick with your long-term investment goal

Make sure you write it down in your investment plan – it will help you focus on your goal and make it easier to manage emotions like fear, anxiety and greed.

2. Protect yourself by diversifying

Ensure your investment portfolio is spread across a range of investments that behave differently under different market conditions.

3. Match your objectives with realistic time frames

If you're saving for a retirement that is 30 years away, you can easily ride out a five year market slump.

Remember, a financial planner can help you understand your investment objectives and associated risks. To find a financial planner in your area, contact the Financial Planning Association on **1800 626 393**, or visit the website at **www.fpa.asn.au**

Eggs and baskets

The importance of diversification

Diversification means spreading your money across different investments to reduce risk. It is perhaps the most important of all investment disciplines. That's why it has become the world's most used and most valuable piece of investment advice – "Don't put all your eggs in one basket".

The more you diversify your investments, the less likely you are to suffer from the poor performance of one investment. Spreading your investments reduces your overall volatility, whether you invest in a managed investment or directly into assets (such as shares).

Unfortunately, too many investment portfolios are poorly diversified – and that can be expensive. A study[3] followed the results of 60,000 individual share investors and showed that a vast majority of individual investors were under-diversified, taking too much risk and losing money as a result. On a risk-adjusted basis, the least diversified group of investors earned 2.4% less each year than the most diversified investors.

According to their report, over 25% of portfolios contained just one stock. 50% contained fewer than three stocks and only 5-10% of portfolios contained more than ten stocks. As a result, investor portfolios were extremely volatile.

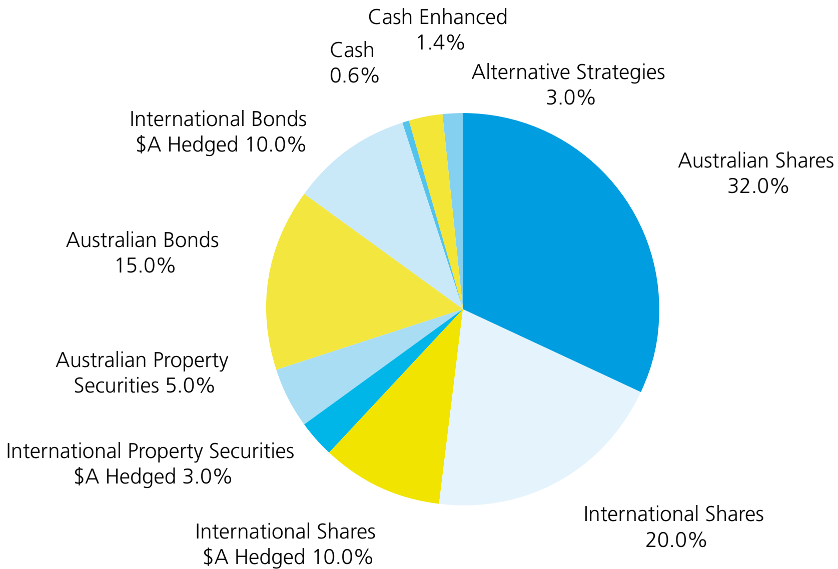
The pie chart on the next page gives an example of the level of diversification achieved by investing in a diversified portfolio – such as a balanced fund.

[3] *Goetzmann, William N. and Kumar, Alok, "Diversification Decisions of Individual Investors and Asset Prices" (January 14, 2004). Yale ICF Working Paper No 03-31.*

More than one kind of diversification

Professional investment managers normally produce better returns than individual investors. Yet it is equally important to diversify across managers as well as asset classes. Different managers have different skills and perform well under different conditions. Your financial planner can help you choose a mix of fund managers that suit your needs and have complementary investment styles.

Diversifying across shares, cash, bonds and property potentially reduces your risk, whether those asset classes are owned direct or are within a managed fund. It also plays a crucial role in tailoring your investment portfolio to your needs. Just as no two investors are the same, no two diversification strategies need be the same. You can work with your adviser to ensure your mix of assets meets your needs for both risk and return. This asset allocation process is one of the crucial parts of investment strategy.



Graph prepared by Russell Investment Management Ltd. The pie chart indicates asset allocations of a 'typical' Balanced Fund. The composition of this chart may change.

Please note that asset allocation would vary depending on individual circumstances.

Flight risk

Managing currency risk

"Take calculated risks. That is quite different from being rash."

General George S. Patton

Today we can invest almost anywhere in the world. Australians can profit from the performance of Microsoft (US), Vodafone (UK) and Samsung (South Korea). Investors from as far apart as Bangkok and Birmingham can invest in Australian companies like BHP Billiton and Westfield.

International investing doesn't just give us exposure to bigger and better companies. It also increases diversification – expanding, literally, the universe of stocks you have to invest in. That's why investing overseas can increase returns and reduce risk.

Different countries, different currencies

Investing internationally has its own risks. By buying overseas assets, you are taking a risk on the relative value of the Australian dollar against other currencies.

As we have seen recently, relative value moves dramatically. In 2003, the Australian dollar rose 33% against the US dollar and finished the year valued at around 75 cents US. As a result, any gains received from investing in US shares were reduced by the worsening value of the US dollar against the Australian dollar. In 2001, it was worth just 48 cents. Currency moves of that type can wipe out any return you generate from the overseas assets. Alternatively, they could generate a currency-related profit.

Hedging for protection

To control this risk, many fund managers hedge their international investments. Hedging is complex, but essentially means managing the risks of a movement in the value of your international assets and therefore helps to protect these assets from currency movements.

A fund manager's currency management process can be a major influence on returns from international funds. It's an important issue to look at when you're working with your adviser to choose an international fund.

Rainy-day money

Liquidity risk

"There are risks and costs to a program of action. But they are far less than the long-range risks and costs of comfortable inaction."

John F. Kennedy

Sometimes, unforeseen circumstances force us to draw on the money in our long-term investments. This can result in a loss, either because there are transaction fees or because we have to sell investments when their market price is down.

That's why it's wise to keep some 'rainy-day' funds in an accessible, short-term investment (such as a Cash Management Trust or 'CMT').

It's equally important you understand the liquidity profile of your investments. How long will it take you to redeem money from your investment? Remember, for all its advantages, direct property is likely to be your least liquid investment as it will typically take longer to sell.

Once you have your short-term needs taken care of, you can be confident your long-term investments can remain just that – long-term! Good planning means you can handle emergencies without affecting your long-term goals.

Case study – Joan, 53

Joan's financial planner always stressed the need for liquidity. "It never really made sense to me," says Joan. "I wanted the best possible return from my money and knew that meant investing in shares and property.

I had a good income and didn't need to use my savings so it seemed a bit silly to keep money sitting in cash.

Nonetheless, I took my planner's advice.

Then my daughter, who was living in London, had a car accident. She had to have emergency surgery and weeks of follow-up treatment. Thanks to my separate cash fund, I was able to get on a plane almost straight away.

If I had to, I would have sold investments to be with my daughter. But that might have taken a week – and I could have lost money selling my shares when the market was down. At a really stressful time, it was an enormous relief to have emergency funds to call on."

This is a fictional case study. It is an illustration only and any similarities to any reader's circumstances are purely coincidental.

Trust issues

Credit risk

"An investment in knowledge always pays the best interest."

Benjamin Franklin
(1706-1790)

Credit risk applies to investments such as term deposits, debentures and bonds. It is the risk that the company you have entrusted your money to will become insolvent – unable to meet interest payments or to repay your funds.

Information is the key to managing credit risk. If you're considering an investment, ask for information about the company's credit rating, past performance and ownership. This should give you some indication of the quality of the organisation. Once again, understanding the risk/return trade-off is important. Bonds or debentures that are riskier have to pay a greater return to attract investors. That's why government bonds generally pay less than corporate bonds and why bonds issued by blue-chip companies generally pay less than those issued by new or smaller companies.

Diversification will also help you manage credit risk. By spreading your money amongst a number of institutions, you can reduce the effect a credit problem in one investment could have on your investment portfolio.

Credit ratings

Ratings agencies like Standard & Poor's (S&P) rate investments such as bonds, cash management trusts, investment bonds and approved deposit funds. The highest rating available is 'AAA'. S&P considers funds rated from 'AAA' to 'BBB' to be 'investment grade', that is, to have the capacity to pay income and repay funds in a timely manner.

Changing rules

Legislative risk

"Government's view of the economy could be summed up in a few short phrases: If it moves, tax it. If it keeps moving, regulate it. And if it stops moving, subsidise it."

Ronald Reagan

When you plan your individual investment strategy, you naturally make decisions based on the laws and regulations at the time.

There is always a risk that the rules could change. This is especially important in superannuation and social security where Australian governments of both major parties have made many major legislative changes over the years, especially changes to superannuation implemented 1 July 2007.

A financial planner can explain the legislative risks of a particular investment and help make sure you will not be locked into an unsatisfactory strategy should the laws change.

Loopholes and legislation

Governments don't like changing investment laws that are well-established and trusted by large numbers of voters e.g. negative gearing.

Indeed, much of the complexity of today's superannuation legislation is the result of governments changing the superannuation laws, and at the same time, trying to make sure people who invested under the old laws will not be disadvantaged.

Where legislative risk becomes a real problem is if investors try to take advantage of short-term loopholes or weaknesses in government regulation. Governments are much more likely to amend those regulations without warning or compensation.

That's why it's so important to judge each investment on its investment merits… not on the chances of special, one-off tax advantages.

Doubling up

Gearing risk

Gearing is simply borrowing to invest

Investors 'gear' if they borrow to buy shares, property, or other assets so that they can increase their returns. Obviously, the more money you invest, the greater the cash return you receive for every percentage point of growth or income your investment generates.

However, the more you invest, the greater the loss you can make if the market turns against you. So gearing can have substantial risks and these risks increase the more volatile the underlying investment.

There are many ways to manage gearing risk. You can limit the amount you borrow, buy only quality investments and make sure you are investing for a suitable time. You can also take out insurance (such as life, trauma and income protection) to protect the income that pays the loan.

Your financial planner can fully explain how any gearing will change the risks in your investment portfolio and help you devise a strategy to manage those risks.

Different assets, different risks

"There is good news. The financial tools that will allow ordinary folk to cope with increased uncertainty, and to insure against adverse economic events, are already being developed."

Robert Schiller
US economist and author of "Irrational Exuberance"

Each of these four major asset classes – cash, fixed interest, shares and property – has unique characteristics.

Cash

Includes cash management trusts and on-call deposits with banks, building societies and credit unions.

Fixed Interest

You receive an income in return for the loan of your money over a fixed term. See page nine for more information on fixed interest investments.

Shares

Shares are traded on a stock exchange and are generally liquid. They represent part-ownership of a business and entitle you to share in a company's income and any growth in its value. Historically, shares have delivered the best long-term returns of the major asset classes.

Property

Can be residential, commercial, retail, industrial or rural. Direct property is relatively illiquid. By investing in listed property securities traded on a stock exchange you can enjoy better liquidity, though you will need to manage many of the risks associated with share investing.

A suitable choice

The table below shows some of the potential risks associated with each asset class.

With careful asset allocation, you can mix the different asset classes, each with different levels of return, liquidity and volatility, into a portfolio that is tailored to your needs.

Asset	Features	What do I need to know?
Cash	The capital is safe relative to other asset classes. You have quick access to your money.	No protection from inflation or taxation. Returns tend to be lower than for other assets over time.
Fixed Interest	Generally secure – if held to maturity.	Interest rates can vary and may not keep pace with inflation. Can be expensive to convert into cash in an emergency.
Shares	Tend to generate superior long-term returns and growing income. Potential tax benefits. Highly liquid – in most cases.	Volatility could lead to losses if forced to sell. Market slumps can be prolonged. Skill, experience and/or good advice is often required to make right selections. Can be difficult for the direct investor to achieve sufficient diversification.
Property	Capital value and income should rise with inflation. Potential for tax benefits. Emotional security of 'bricks and mortar'.	Illiquid. Managing tenants can be difficult and costly. Often involves large sums of capital, significant debt and numerous costs such as legal fees and maintenance expenses.

And now what?

This booklet describes some of the risks involved in investing. As you can see, risk is not something to be scared of. Rather it needs to be understood, accounted for and managed. A financial planner can help you do this. To find a financial planner in your area, contact the Financial Planning Association on 1800 626 393, or visit the Find a Planner service at www.fpa.asn.au

Financial Planning Association of Australia (FPA)

The FPA is the peak professional body for financial planning in Australia, representing approximately 12,000 individuals and businesses. Over 7,500 of its 12,000 members are practising financial planners. The FPA and its members strive to improve the financial wellbeing of all Australians.

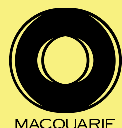
The FPA provides the leadership and professional framework that enable members to deliver quality financial advice to their clients. FPA members include financial planners from a variety of backgrounds and disciplines, including over 5,500 CERTIFIED FINANCIAL PLANNER™ professionals – CFP® certification is the only globally recognised mark of professionalism for financial planners. All FPA practitioner members are bound by a code of ethics, high professional standards and must meet continuing professional education requirements.

This booklet is provided for general information only by the Financial Planning Association of Australia Limited ABN 62 054 174 453. It should not be considered a comprehensive guide, nor used as a substitute for professional advice.

This information is of a general nature only and does not take into account the individual objectives, financial situation or needs of any particular investor. Before acting on this information you should consider whatever is appropriate in regard to your objectives, financial situation and needs.

The Trade-Off: Understanding Investment Risk is a revised edition of the brochure jointly published in 2005 by FPA and Macquarie Investment Management Limited (MIML). MIML has not reviewed the revised edition and, so, does not endorse the revised content and is not liable for it.

All content except graphs in this revised edition have been provided by TOWER Australia Limited (ABN 70 050 109 450, AFSL Number 237 848) except where indicated.



Financial Planning Association of Australia

Level 4, 75 Castlereagh Street
Sydney NSW 2000
Phone 02 9220 4500
Fax 02 9220 4580

Level 8, Marland House
570 Bourke Street
Melbourne VIC 3000
Phone 03 9627 5200
Fax 03 9627 5280

fpa@fpa.asn.au

www.fpa.asn.au

FPA
FINANCIAL PLANNING
ASSOCIATION OF AUSTRALIA

© FPA December 2008