Investment Concepts – Investment risks

All investments carry some degree of risk. As a general rule, higher risk investments have a higher potential return, but higher risk also means an increased chance that the investment will not achieve that return, particularly over the short term.

This risk/return trade-off is important. You need to ensure that you are comfortable with the level of risk taken so that it can help you achieve your financial goals but still allow you to sleep at night without worrying about the impact of a financial downturn.

The key investment risks you should be aware of are listed below.

Diversification risk

Diversification risk is the risk that if you put all of your assets into one asset class (one 'basket') then your portfolio is at risk of being adversely affected if that asset class falls in value.

The major asset classes include Australian and international shares, listed property, Australian and international fixed interest and cash. Every asset class has its bad years, but when one asset class is performing poorly, another asset class will usually be doing well.

Diversifying your portfolio across these major asset classes means that when one asset class falls in value, it can be offset by other asset classes that are performing well at that time. It also means that if one asset performs poorly it only affects a portion of your overall portfolio.

Inflation risk

Inflation risk is the possibility that the return on your investments will not keep pace with inflation. If this happens, your 'real wealth' declines over time and you may not be able to meet your long-term income needs.

Including shares and property in your portfolio aims to produce positive real returns over the longer term. This is because shares and property are 'growth' assets which, historically, have outperformed inflation over time.

Fund manager risk

There is a possibility that the fund manager you invest with will underperform over an extended period of time. This risk can be minimised by spreading your investments over several fund managers. If one fund manager underperforms it can be offset by other fund managers who may have strong performance at that time.

Currency risk

There is a risk that international investments can be negatively impacted by exchange rate fluctuations. Specifically, as the Australian dollar rises, the value of international share holdings will fall. If the Australian dollar falls, the value of international share holdings will increase.

Investing in a variety of regions attempts to reduce currency risk as your international share exposure will be held in different currencies. You can also consider investment options that (for a fee) hedge against adverse currency movements.

Liquidity risk

Liquidity risk is the risk of not being able to access your funds when you need them (such as in an emergency). This risk can be reduced by using cash reserves that can be accessed immediately in the case of emergency. Alternatively you could invest in managed funds that can generally be accessed within 5 to 15 days, although you may incur a capital loss if the markets have performed poorly.

Regulatory risk

There is always a risk that the government will change legislation in the future to the detriment of your investments. This risk is difficult to plan for and we find it more appropriate to develop strategies based on current legislation but including flexibility into your portfolio can minimise the worry of this risk.

Market risk

Market risk is where an investor experiences losses because of factors that affect the overall performance of the financial markets.

Market risk generally cannot be eliminated through diversification because it occurs across all asset classes. Examples include negative investor sentiment, natural disaster, recessions, economic impacts and political changes that affect market performance. Different asset classes have different levels of market risk.

Market risk can be reduced by investing for an appropriate time-frame for each particular asset class as this gives you time to ride out any downturns.

Market timing risk

The possibility your investment may be sold at a time when the sale price is at a low-point or purchased when the sale price is at a high-point.

Interest rate risk

The possibility your investment will be adversely impacted by a fall or rise in interest rates.

Hedging risk

A technique designed to reduce the risk from part of an investment portfolio often by using derivatives. While hedging can reduce losses, it also has a cost and therefore can reduce profits.

Derivatives risk

Where financial derivatives are used as an alternative to directly owning or selling underlying assets in order to manage risk and/or enhance returns. Risks associated with derivatives can include; the value of the derivative declining to zero; the value of the derivative not moving in line with the underlying asset and, the derivative may be difficult or costly to reverse.

Opportunity cost

The investment return you may forego from an asset as a result of investing in your preferred asset. That is, there is a risk the preferred asset you invest in may not return more than the second-choice (next best alternative) asset you did not invest in.

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