

The two R's

Eight things you need to remember about risk and return.

Macquarie Adviser Services



FORWARD thinking

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The trade-off

Typically, investors think about risk or return. Some focussing only on maximising returns without measuring the risk taken to achieve those returns. Others are so worried about losing money that they completely avoid risk altogether – which risks reducing their wealth over time.

Yet the single most important lesson you can learn is this – risk and return cannot be separated.

When it comes to investing, the more risk you take, the higher your potential return. However, there are different types of risk and many change over time or have different implications depending on your time horizon, attitude towards volatility and stage in life. Also, by *managing* risk it may be possible to get more return for a given level of risk.

Risk – a common sense definition

Risk is 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 return you should receive. This is the 'risk/return trade off'. It is one of the key concepts of investing.

'The policy of being too cautious is the greatest risk of all'

Jawaharlal Nehru (1889–1969)

Not all risk is bad

All investments involve risk. However, it is important to distinguish between an investment which is volatile in the short-term but may achieve strong long-term gains, and assets of such poor quality they can never be anything but a bad investment.

Investing in the sharemarket involves day-to-day fluctuations – sometimes extreme ones – but historically have always delivered capital growth over the long term.

When you invest in cash-type investments, the capital you invest – in a bank or government or semi-government institution – is usually deployed conservatively, keeping day-to-day volatility low – and capital returns are limited as a result. When you put your money into shares or property there are a wide range of

factors which influence those markets and therefore a much wider dispersion between strong and poor performing investments. You receive a reward (higher returns) for identifying the superior investments.

While taking on the ‘right’ degree of market risk is essential to growing your capital over time, it is critical to look at the type of risk you are taking and avoid investments which will not be rewarded with higher potential returns.

Market risk refers to the amount by which an investment may rise or fall in value due to market factors. These may include changes in share prices, interest rates, currency or commodity prices, etc.

Risk changes over time

Time can smooth market volatility. Therefore the amount of investment risk you take on may change significantly depending on how long you are going to hold that investment.

Consider the sharemarket. While day trading may sound very profitable, you are at significant risk of losing some of your money. History has shown, however, that investing over the medium to longer-term (say five years or more) is far more effective for capital appreciation.

The chart on the next page highlights how large daily swings are hardly noticeable for an investor aiming to grow their wealth over the longer term.

Not everyone has the luxury of time. When investing, it is vital to consider how many years you are investing for. Will you need regular cashflow or some of your money along the way? Only once you are comfortable with this and other issues can you identify investments which carry the appropriate level of risk for you.

Mismatch risk is the risk that the investment you choose may not suit your needs and circumstances. Being overexposed to growth assets when you need security is a mismatch risk. So is having all your money in cash when you need a growing income to sustain your lifestyle.

The risks you don't see and can't control

Time and Risk: a case study

The chart below shows the performance of the Australian sharemarket since 1900. As you can see, if you invested during the 2000–2004 period it is likely your returns would have been flat or even negative. Investing over the long-term was much more profitable. An investment made at the beginning of 2000 would have more than doubled your money – despite the weak returns in the early years.

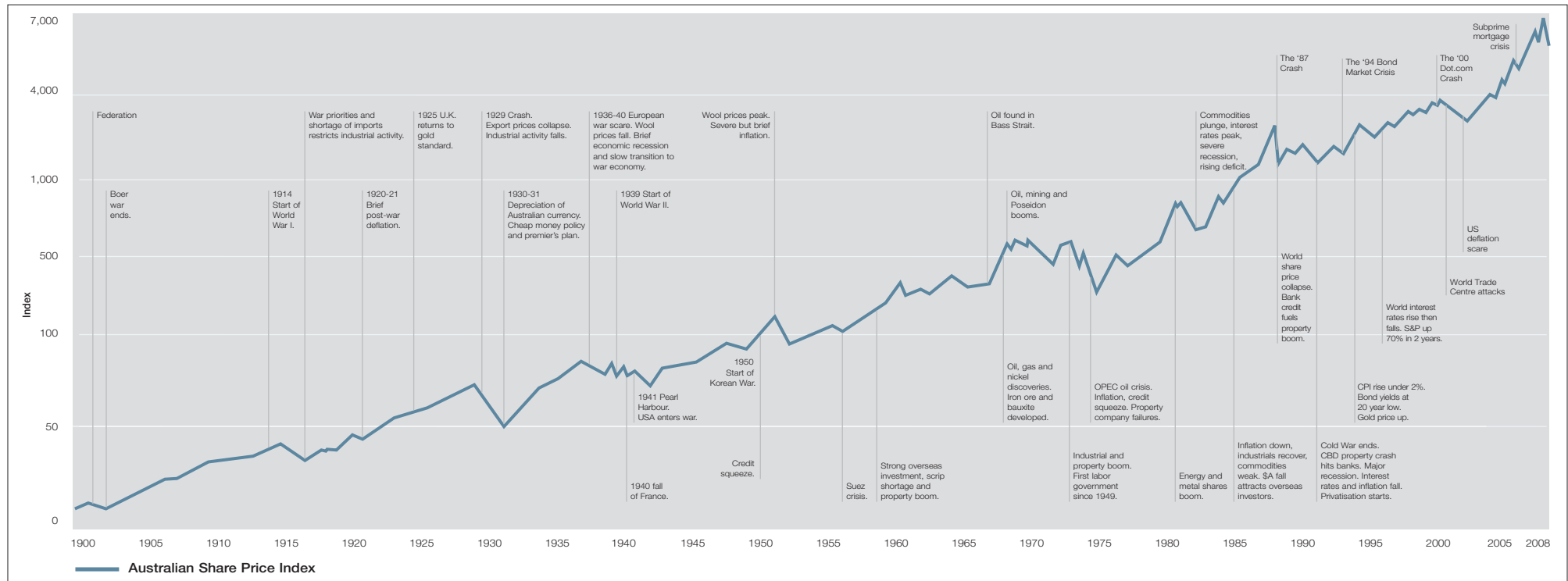
Some risk is invisible. While we hear about swings in company stock prices every day, when it comes to houses, price movements are reported less frequently.

In fact, for many people, the loss or gain associated with a property investment is only really measured when you are selling.

Often it is the more frequently traded investments which appear to be more 'risky'. Yet the fact that they are more

liquid makes them *less* risky. If you need to sell, there is a market with enough demand to provide you with the needed cash. In less liquid markets it can become necessary to significantly reduce the price you are asking to attract a buyer or wait longer for a buyer.

Australian sharemarket (S&P/ASX 300 Price Index)



Why not taking risk can be risky

Many people forget that by not actively seeking exposure to market risk you may be significantly reducing your potential wealth to grow over time.

While storing a pile of money under your mattress may protect you from downturns in the property and share markets, it can still be a risky strategy. As our economy grows, the cost of living increases (inflation) meaning that unless you are growing your savings at least at the same rate, the real value of your money is falling.

Also, without adequate exposure to major asset classes (such as shares and property) you risk missing out on global developments which cause capital growth in investment markets. In the past decade, for example, you would have completely missed out on the investment gains associated with the industrialisation of China and the resources boom, growth from substantial technological developments like the internet and mobile phones and massive booms in both the Australian share and property markets.

Inflation risk refers to the fact that the purchasing power of your money can be reduced by inflation over time.

Different people, different risks

What's the most important factor when it comes to investment risk?

You.

Your life-stage and investment time horizon is vital to determining what type of risk you should take on.

While a sharemarket investment may be a relatively low risk long-term investment strategy for a person aged in their 20s – with many years to weather the ups and downs of the market – the same investment may be highly risky for someone counting on the money as they move into retirement.

Different life-stages come with different financial and family commitments – and this has implications for the risk you can bear. Broadly, the level of investment risk a person takes on will relate to their time horizon, financial and family situation.

■ **The young** – those with relatively small financial commitments or family obligations may benefit from more aggressive investments (such as shares and property), thus harnessing the power of volatility to enhance long-term capital growth.

■ **The families** – people with dependent children, large mortgages and other commitments need to ensure their investments are both working hard and have capital to fall back on in an emergency. In this case a mixed (diversified) portfolio of both aggressive and defensive (cash and fixed income) assets may be appropriate.

■ **Retirees** – traditionally those about to retire sought the security of lower risk-investments so they had a predictable amount of capital and cashflow to draw on when they stopped working. Today our longer life spans and when we choose to retire have changed this equation. Retirees need to balance the desire for capital security with assets that maximise their returns so that their capital grows over time and protects their standard of living from the ravages of inflation.

'Hesitation increases in relation to risk in equal proportion to age'

Ernest Hemingway

How to manage risk and achieve financial independence

Diversification – spreading your money around – is one of the most important and effective risk-management tools.

Today, diversification involves blending the right combination of asset classes (shares, property, bonds, cash etc) and blending across managers and countries as well.

The 'right' kind of diversification again depends on you. You want to build a diversified portfolio that helps you seek your desired long-term return goals but within risk boundaries you are comfortable with.

Your risk management checklist:

- **Have you a clear long-term goal?** By having a goal and a plan you can focus on what you want to achieve, take a structured approach and remove the tendency for emotions like fear and greed to influence your decisions.
- **Can you balance and rebalance?** Diversification should involve a spread of investments that perform differently under different market conditions (that way you won't get badly hurt by any one market fluctuation). You need to reassess these investments regularly or after significant market movements to ensure your portfolio is still evenly spread (a significant rise or fall in the value of one investment type could throw your portfolio out of balance).
- **What's your timeframe?** Ask yourself when you will need the money. If you're saving for a retirement that is 30 years away you can easily ride out a market slump.

Would you like to achieve financial independence?

Financial independence = building personal cashflow, to replace your employment cashflow, to meet your cost of living cashflow.

Who can help you?

A financial adviser can help you make a detailed assessment of your financial situation, investment time horizon and life stage. They can then select products and strategies which match your risk profile and return objectives.

How to contact Macquarie Adviser Services

Financial Planning Association

 1800 626 393


 www.fpa.asn.au

Macquarie

 **Investors**
1800 806 310

 **Financial Advisers**
1800 808 508

 macquarie.com.au/personal

 PO Box 192
Australia Square NSW 1215