

Understanding investment risk is key to developing a successful investment plan. There are three main types of investment risk. While all investments potentially have these risks, all three can be managed and minimised.



1. Permanent loss of capital

This is the risk the majority of investors fear most – the thought of losing all of their money.

It is this risk which gets most of the newspaper headlines, but in reality it is the risk which can most easily be avoided – whether the investment is shares, property, cash, fixed interest or mortgage trusts.

The key with managing this risk is firstly to buy only quality investments and, secondly, to buy a number of investments so that if one does fail, it will have only a small effect on your overall portfolio.

So, should you accept the risk of permanent loss of capital? Are the rewards worth the risk? The answer is yes and no.

No, you shouldn't accept the risk of loss of capital associated with poor quality investments. The risk is too high, and the rewards are often illusory.

But, yes, you should consider accepting the risk of loss of capital associated with high quality investments. The risk is low, and the potential returns are acceptable. Moreover, the risk can be minimised with the help of a diversification strategy.

2. Fluctuating returns

In one way or another, all investments suffer from this risk, even term deposits.

While they guarantee you a return during the term of your investment, there is no guarantee on the return when it comes to re-investing your money. You may have to sign up for a much lower return on re-investment.

The asset class which has the greatest risk of fluctuating returns is shares. Their values can change on a minute-by-minute basis. Even over longer time-frames share returns can fluctuate strongly.

However, with quality investments the returns will fluctuate upwards more often than they will fluctuate downwards. In so doing, they will reward you with a superior return. As Graph 1 highlights, despite short-term volatility, the value of the Australian sharemarket has increased substantially over the past 60 years.

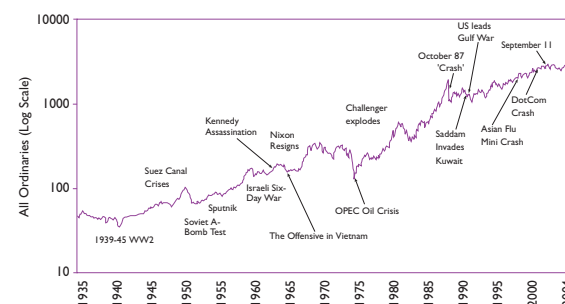
You can minimise the risk to your portfolio of fluctuating returns by:

- investing in quality investments
- investing for the long-term
- diversifying your investments.

Graph 2 shows how investing over a longer timeframe

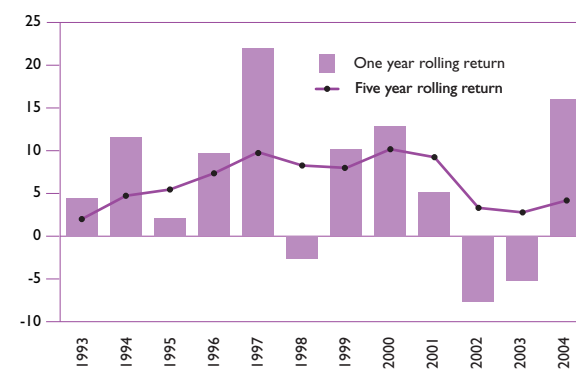
diminishes risk. The Australian sharemarket has had a number of negative single-year returns since 1993. However the graph shows that keeping your investment for five or more years substantially diminishes the risk of negative returns – there has not been a single negative 5-year return in this period.

Graph 1: Australian Sharemarket always bounces back
Following a fall, the market has never failed to rise above the previous high point



Source: ASSIRT Research

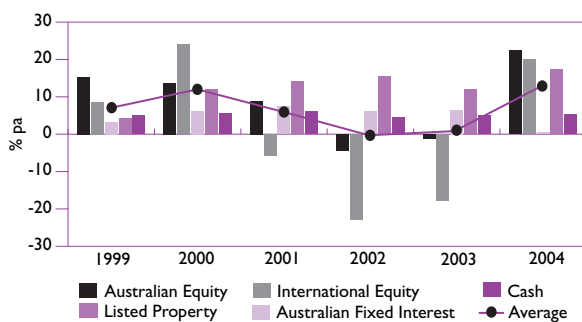
Graph 2: Invest for the long term



Source: St. George Investment Solutions

The third way to minimise risk is to diversify your investments. Graph 3 shows how a diversified portfolio smooths your return. The line is the return you would have received had you invested in a basket of all the asset classes rather than any particular one. You can see that the highs and lows have been smoothed out along the way, providing you with a more consistent return.

Graph 3: Diversification can smooth your investment return
 Annual asset class performance to June



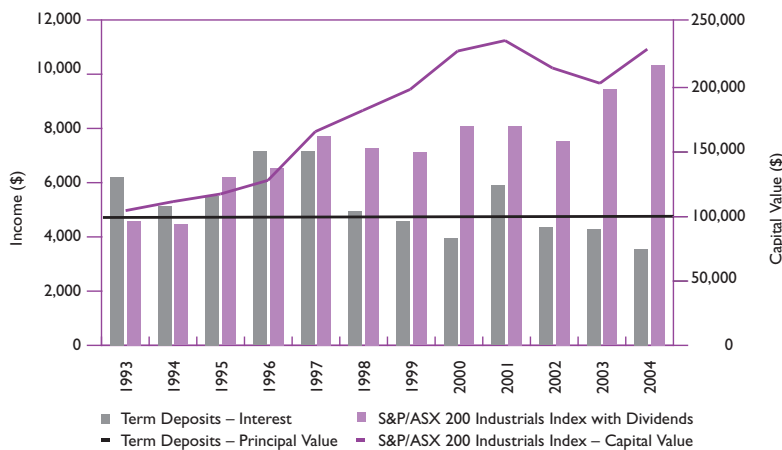
Source: St. George Investment Solutions

3. Not achieving your goals

This risk occurs when people do not use investments which will generate a sufficient return in order for them to meet their financial goals. It typically occurs when people decide to 'play it safe' by investing in cash and term deposits to ensure that they do not lose capital.

However, this can sometimes lead to a worse fate. Graph 4 shows the difference in the long-term returns of investing in term deposits compared with industrial shares. The income and capital value generated from the share portfolio outperforms that of the term deposits.

Graph 4: Return on Investment of \$100,000
 Invested in June 1993



Source: ASSIRT Research



Steve Waugh chooses ASGARD – here's why you should too:

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