A guide to investment risk

Understanding investment risk is the key to developing a successful investment plan. While every investment has potential risks, these can be managed.

Everybody worries about risk. By getting the right guidance you can keep risk in perspective and identify the types of risk that are acceptable and those that are best avoided.

Permanent loss of capital

This is the risk that you probably fear most – the thought of losing all of your money.

It's this risk which gets most of the newspaper headlines, but in reality it's the risk which can most easily be avoided.

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

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

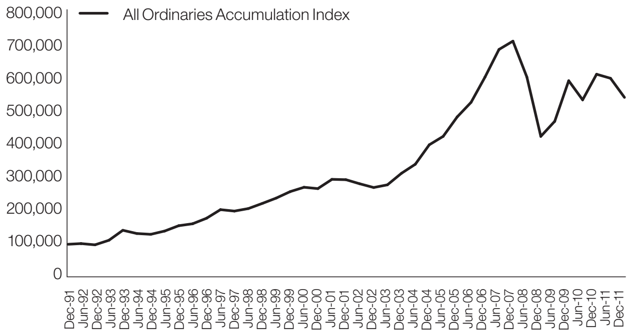
No, you shouldn't accept the risk of loss of capital associated with poor quality investments. The risk maybe too high, and the rewards are often illusionary.

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

Graph 1: Australian share market bounces back

Following a fall, the market typically rises above the previous high point

Performance to December 2011



Source: Bloomberg, eQR securities

Fluctuating returns

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

The asset class which fluctuates the most is shares; their values can change on a minute-by-minute basis. Even over longer timeframes, share returns can fluctuate strongly.

As Graph 1 highlights, despite short-term volatility, the value of the Australian share market has increased substantially over the past 20 years.

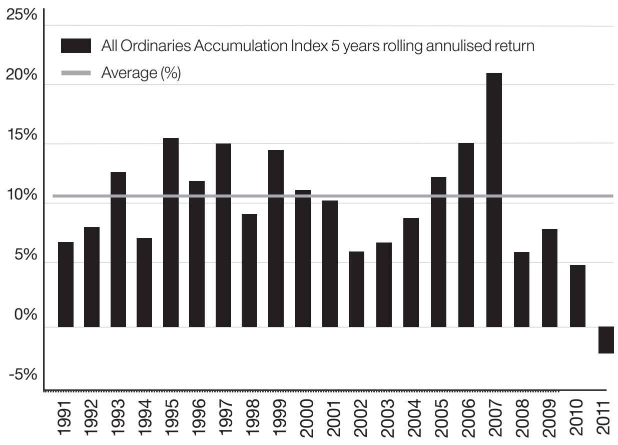
You can reduce the risk to your portfolio of fluctuating returns by:

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

Graph 2 shows how investing over a longer timeframe reduces risk. The graph shows that keeping your investment for five or more years substantially reduces the risk of negative returns. The third way to minimise risk is to diversify your investments.

Graph 2: Invest for the long-term reduces risk

Five-year rolling Australian All Ordinaries Accumulation Index annualised returns to period ending 31 December 2011

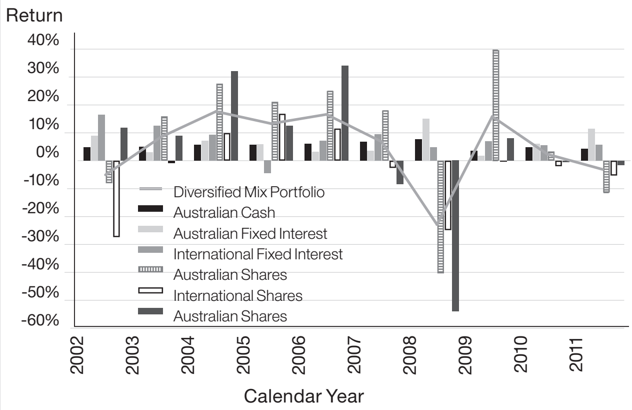


Source: Bloomberg, eQR securities

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: Return for diversified mix versus each asset class (last 10 years)

Invested in January 2002 to December 2011



Source: Bloomberg, eQR securities

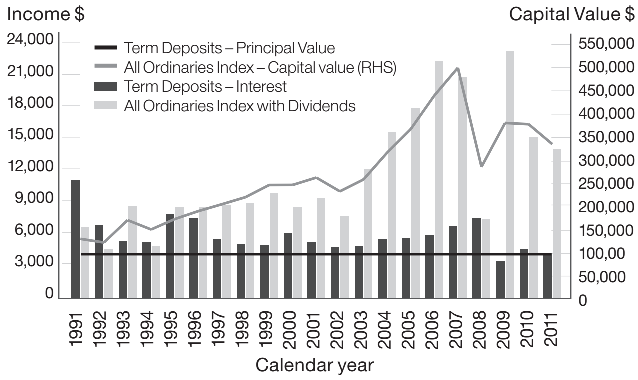
Not achieving your goals

This risk can occur when you don't use investments which has the potential to generate a sufficient return to meet your financial goals. It can occur if an investor decides to 'play it safe' by investing in cash and term deposits to ensure that they don't lose capital.

However, this can sometimes lead to a worse fate – not having enough money to achieve your goals.

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 from January 2002 to December 2011



Source: Bloomberg, eQR securities

Things you should consider

Speak to your financial adviser. They will help you work out what level of risk you're comfortable with and recommend investments that can bring you closer to your goals. Your financial adviser can give you a copy of the relevant Product Disclosure Statement for any financial product you are considering and you should read this document carefully before making any investment decision.

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