

# Insights

Tools for sound decision making

February 2009

This issue covers:

## How you can turn risk in your favour.

Rather than considering all risk as bad and to be avoided, consider that, in reality, accepting some form of risk is an essential element in helping your investments produce desirable long-term returns.



## Overview

### Introduction

- » Risk is an important consideration in any investment.
- » Accepting some form of risk is an essential element in meeting long-term objectives

### Six faces of investment risk

- » Asset Class Risk
- » Active Management Risk
- » Interest Rate Risk
- » Inflation Risk
- » Currency (or exchange) Risk
- » Timing Risk

### Understanding the risk/return trade-off

- » Assuming a higher level of risk can result in higher returns
- » Asset allocation should be based on an investor's individual situation, i.e. investment objective, time horizon and risk tolerance
- » Investing too conservatively for a long-term goal can result in insufficient long-term returns

### Risk management strategies

- » Set a clear objective and commit to some basic investment strategies
- » Diversify your investments by asset class, investment style and multiple fund managers
- » Adopt regular practices such as rebalancing and regular investing to eliminate emotional decisions
- » Among the best risk reduction strategies is to invest for the long-term

# Introduction

Mention the word 'risk' when talking about investments and most people instinctively think you are talking about the possibility of losing money. This is an important consideration, but there is a lot more involved in understanding the risks surrounding investments.

And it's not all bad news. For example, did you know you can turn risk to your advantage and profit by it? In this edition of Insights, we explore the different sources of investment risk, explain the trade-off between risk and return and discuss various strategies for successfully managing investment risk.

Investment risk is something many people have been thinking over the past few months. Volatility has returned to the markets and Australian investors are facing the first period of negative returns in six years.

The temptation for many may be to their superannuation straight into the latest high-performing fund. But chasing returns rarely brings rewards. It is important to put emotions aside, concentrate on your overall financial objectives and stick to a clear long-term financial plan.

The terms 'investments' and 'investment risk' relate to all of us, no matter how much money we have to invest. Every time we choose how to spend our money – no matter how small an amount – we are making an investment decision. Buying a house is an investment decision, so is depositing your pay into a bank account, buying some shares, or putting a few coins into a piggy bank. And there are various types of investment risk attached to every investment decision we make.

Rather than considering all risk as bad and to be avoided, consider that in reality, accepting some form of risk is an essential element in helping your investments produce desirable long-term returns. As we shall see, you cannot completely avoid risk anyway (even a humble deposit in a bank account faces risks), so if you can't eliminate it, you may as well use it to your advantage.

## Six faces of investment risk

### 1. Asset class risk

Asset class risk refers to the possibility that the performance of a particular asset class could differ from another asset class. While each asset class is exposed to various risk factors, some asset classes are naturally more volatile than others. You can think of volatility as a measure of return dispersion i.e. the higher the volatility, the higher the risk of not achieving a consistent level of returns from that investment from period to period.

Figure 1 shows the range of returns posted for Australian shares, Australian bonds and cash and also their long-term average return. It can be seen that while shares have the highest average return (over the long-term), the returns also differ the most from year to year (highest volatility). The opposite is true of cash – there is little variability in returns from year to year, but has the lowest average return.

Figure 1 – Range of calendar year returns &amp; long-term average returns for various classes

Asset Sector	Risk (%)		Return (% PA)
	Lowest Return	Highest Return	Long Term Average Return
Australian Shares	-17.5	+66.8	14.1
Australian bonds	-4.7	+24.7	10.3
Cash	+7.8	+18.4	9.1

Source: Calendar Year Data 1983-2007.

Australian Shares: S&P/ASX 300 Accum. Index, ASX All Ordinaries Index Prior to 31 March 2000.

Australian Bonds: UBS Warburg Aust Composite Bond Index, Commonwealth Bank All Series All Maturities prior to 1990.

Cash: UBS Warburg Bank Bill Index. Australian 91 Day Treasury Notes prior to 1988.

Some investors aim to avoid volatility, and mistakenly think they are also avoiding risk, by investing primarily in cash. However over the long-term, the risk of underperformance by investing in cash is virtually guaranteed and can result in a failure to achieve your financial objectives. The returns generated by cash are typically 4-5 per cent lower than those generated by shares over longer periods.

*“The further an active manager deviates from a portfolio benchmark, the greater the risk.”*

## 2. Active management (or benchmark) risk

A benchmark is a selected measure (usually a market index) chosen for the purpose of comparing results. For example, we may choose the ASX/ 300 Index as a benchmark against which we can compare the returns of various Australian share funds.

Investors are interested in benchmark risk because they are faced with the choice of:

- with a passive fund manager who charges minimal fees and aims to provide a return equal to a nominated benchmark (or market) return (also known as beta). Hence there being minimal benchmark risk when investing with a passive fund manager; or
- investing with an active fund manager, whose fees are higher than those of passive managers, but who aims to provide a return above the benchmark. Investing with an active manager means benchmark risk is higher but in return, investors gain the opportunity of achieving above benchmark returns (also known as alpha).

When investors place their money with an active manager they are essentially betting on the skill of that manager. There is an expectation that an investment will perform better than the benchmark, however, there is a corresponding risk that higher returns will not be achieved.

The further an active manager deviates from investing in a portfolio that matches the benchmark, the greater the benchmark risk. Benchmark risk is not a bad thing; for an active manager to achieve above-benchmark returns it must deviate from the benchmark portfolio and have convictions about certain stocks (overweighting in shares it believes will perform well and underweighting in those it believes will not).

## 3. Interest rate risk

At time of writing, the possibility of further interest rate rises is of major concern to many Australians. Interest rate risk affects different securities and asset classes differently. When interest rates rise, fixed interest securities (such as bonds) lose value.

New securities are being issued at a higher interest rate than existing securities, so existing securities are worth less. For example: why would someone buy a \$10,000 government bond paying 5 per cent a year from an investor wanting to sell, when the government is now issuing \$10,000 bonds that pay 5.25 per cent a year? Of course, the opposite also applies. If interest rates fall, existing securities on higher rates are immediately worth more. While rising interest rates increase the cost of doing business for most companies (as the cost of borrowing increases), some companies and industries, such as banks, actually benefit from rising rates. Rising interest rates also affect residential property investors. As interest rates rise, so do investors' loan repayments.

#### 4. Inflation risk

Inflation erodes the buying power of our money and reduces the value of our income and assets. Inflation risk is particularly relevant for those people who invest most or all of their money in cash and fixed interest investments.

If you have any doubt as to the large impact that inflation has on your investments, consider the following examples. In the 2007 calendar year, a cash investment would have generally returned around 6.7%.

*“Inflation erodes the buying power of our money and reduces the value of our income and assets.”*

Allowing for an average tax rate of say, 35%, leaves you with 4.36% return after tax. We have to adjust now for the impact of inflation, so we take another 2.5% away, leaving you with a 1.86% real return on your cash investment. The situation wasn't all that different twenty-something years ago – a time when cash investments were returning 11.1%! Again, allowing for 35% tax, your after tax return is 7.2%. Inflation in 1983 was hovering around the 8.6% mark. A 1983 investor's real return on a cash investment? A loss of 1.4%.

#### 5. Currency or exchange risk

Investments in international assets are affected by fluctuations in currency values. A 'strong' Aussie dollar can buy more foreign goods, including international shares. If the Aussie dollar falls in relation to other currencies, the value of our international investments automatically rises (even though their price in local dollar terms hasn't changed) as more of our 'weak' Aussie dollars are now needed to buy the same amount of those foreign shares. It is also worth noting that many Australian companies earn revenues in other countries and in other currencies. So, some companies can benefit from a falling Australian dollar while some gain from it.

#### 6. Timing risk

The fear of losing money has caused many investors to attempt to manage returns by timing the market. That is, trying to work out how certain asset sectors will perform in the short-term and then buying or selling accordingly. Russell research has shown that no-one, even professional investors, can correctly time the market on a continual basis.

Individual investors are notorious for timing it incorrectly, buying in droves in the excitement of market highs and selling in droves in the despair of market lows.

Investors that focus on short-term fluctuations are more likely to make irrational investment decisions. The fear of losing money can cause them to shift out of more volatile investments, such as shares, to perceived safer holdings, such as cash trusts, or perhaps sell up their investments altogether. In an attempt to subdue performance anxiety, many investors open themselves up to market timing risk by selling low and locking in losses and subsequently missing opportunities for growth when the market rebounds.

The importance of being disciplined, sticking to your plan and staying invested over the long-term can not be underplayed. If you were fully invested in Australian shares since January 1980, a \$10,000 investment would have been worth \$403,840 at the end of December 2007 – an annualised return of 14.1% per cent. If you missed the three best months during this period, your investment would be worth significantly less, round \$207,964. If you missed the ten best months of the market over the period, your investment would now be worth \$102,948.

These six specific risks combine in various forms to produce a more general – yet common – risk that every investor faces: **The risk of not achieving your financial objectives and the risk of not having enough money for retirement.**

## Understanding the risk/ return trade-off: how much risk is right for you?

The first step towards making risk work in your favour is to understand the relationship between risk and return. This relationship is based on the premise that any investor who assumes a high level of risk should be rewarded with a higher return. For example, an investor who can tolerate frequent fluctuations in the value of their investments would generally venture into the sharemarket and accept the greater volatility that accompanies the pursuit of higher long-term returns.

*“Investing too conservatively today can result in you failing to generate a return that is sufficient to meet the financial requirements of your future.”*

Investors whose primary concern is the security of their capital are likely to focus on fixed interest investments and should therefore be willing to accept the lower long-term returns associated with this type of investment.

You must be clear about your goals and objectives. Why are you investing? What is the return you wish to achieve? Are you willing to accept the risks that go with earning that return? Your timeframe is also crucial in any discussion of your personal risk-return trade-off. Are you investing your money for a year or two? Or are you putting your money aside for five, ten or twenty years?

Choosing a mix of investments that is right for you depends on your age and timeframe, your income, your investment objectives and how much risk you are willing to accept.

A financial adviser can work with you to help you determine your risk tolerance and will discuss your investment objectives with you to create a suitable investment portfolio, taking all these factors into consideration. Without the guidance of an adviser you may not accurately determine how much risk you can tolerate, which could result in an investment portfolio with too much, or too little, risk for your situation.

For people approaching retirement this area is of key importance. The uncertainty of government age pension levels in the future means that the responsibility of preparing for a comfortable retirement rests on your own savings and investment planning. Here lies the importance of properly balancing risk and return in your portfolio. Investing too conservatively today can result in you failing to generate a return that is sufficient to meet the financial requirements of your future.

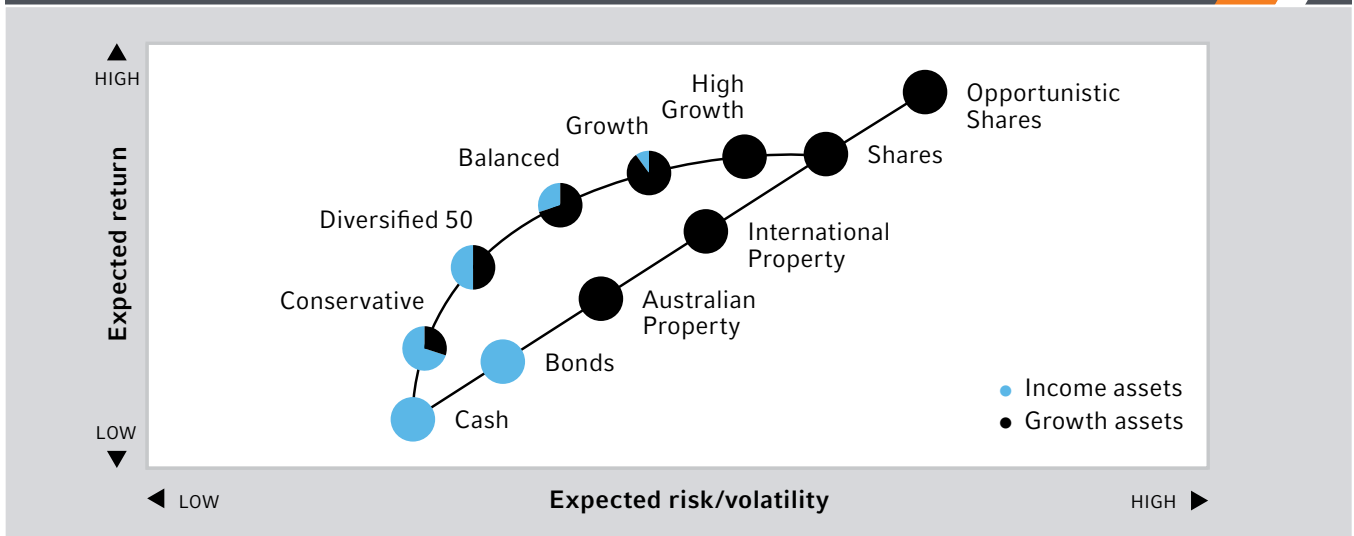
## Risk management strategies

It is possible to use risk management strategies to enhance performance and reduce volatility in your overall investment portfolio. Russell and its partners utilise a number of strategies behind the scenes on the investor's behalf. Some are simple (including Russell's investment strategy of diversifying a portfolio across three levels and continually rebalancing those investments) and many are complex (for example, factor neutral portfolio design, cash equitisation, currency hedging), but they all work together to provide clients with tightly risk controlled returns. For all of the processes Russell combines to control risk, it is just as important for the investor to understand how they can approach managing risk for themselves.

### Set a clear objective

Meeting with your adviser and setting a clear investment objective is an integral part of effectively reducing investment risk. Making a long-term commitment to some basic investment strategies (for example staying invested for the long-term, not chasing past performance, regular investing) can reduce risk over the long-term and eliminate the temptation to resort to short-term measures that can limit or potentially reduce your returns.

Figure 2: Asset classes and their position on the risk/ return spectrum



### Diversify your investments

Diversifying your investments means spreading your money around; not having all your eggs in one basket. It is one of the fundamental rules of investing and the most effective means of managing risk. Diversification means you'll be less affected by losses in any one investment and losses in one area may even be offset by gains in another.

As can be seen in Figure 2, each asset class has its own risk and return attributes and place on the risk return spectrum. Because asset classes often move in different directions and react differently to information, it is possible to reduce your portfolio's volatility and earn a higher expected return for any given level of risk, by investing across a mix of asset sectors. This can be seen on, in Figure 3, in which the balanced portfolio (mix of the seven asset classes) results in reduced volatility and smooths the return versus an investment in any one asset class.

*"The importance of being disciplined, sticking to your plan and staying invested over the long-term can not be underplayed."*

Getting your mix of assets right is the key to meeting your objectives; it is often said that asset allocation explains 80-90 per cent of an investment portfolio's absolute return. In addition, it is important to purchase a broad range of

investments within each asset class, rather than a limited selection of individual securities. This way, no single investment will dominate your portfolio.

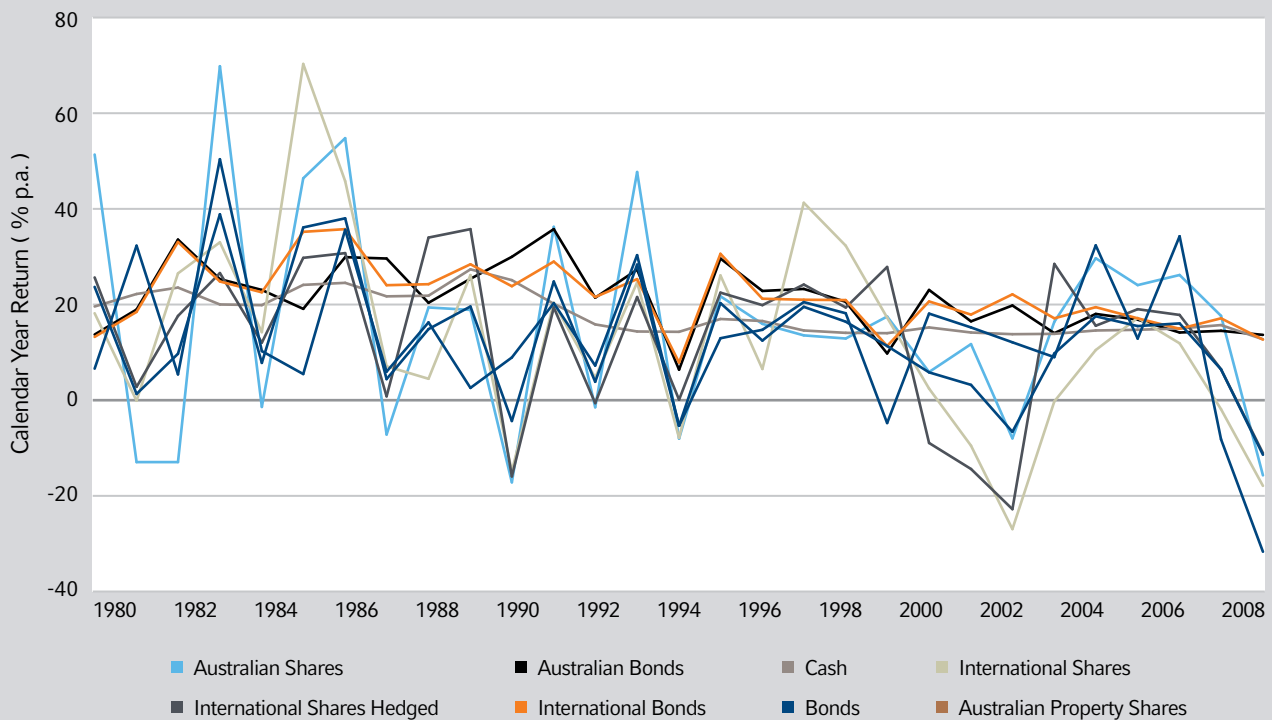
Buying a broad range of investments is usually beyond the scope of most individuals, and so managed funds have become a popular option. These funds invest across a broad range of investments, adding several extra layers of diversification that are simply not available or too costly for individuals to implement. Managed funds do, however, introduce an extra layer of risk: manager risk. This is the risk that the manager you have chosen will not perform as well as other managers, either due to their level of expertise, or the fact that their style of investing may not be suited to current market conditions.

Investing in multi-manager funds, such as those offered by Russell, follow the same principles of diversification as single manager funds with the added benefit that they significantly reduce manager risk by investing with multiple fund managers, balancing and mixing these managers according to their individual investment styles – reducing the reliance on any one particular manager to perform.

### Avoid emotional decisions

Here are a couple of simple strategies that work to reduce risk and enhance long-term returns. Even better, adopting these practices eliminates any confusion or anxiety about whether or when to buy or sell your investments. The decision is automatic and unemotional, making it easy to stick to your long-term plan.

Figure 3: How blending asset sectors to create a diversified portfolio results in reduced volatility



Source: Russell Investments; Australian Shares—S&P/ASX 300 Accum Index, ASX All Ordinaries Accum Index prior to 31 March 2000. Australian Bonds—UBS Warburg Aust Comp Bond Index, 1980-1989 Commonwealth Bank All Series All Maturities. Cash—UBS Warburg Bank Bill Index (Australian 91 Day Treasury Notes prior to 1988). International Shares—MSCI World Net Div Reinvested Accumulation Index (\$A) and International Shares Hedged: MSCI World Net Div Reinvested Accumulation Index \$A Hedged, MSCI World Local Currency Index prior to 1988. International Bonds: Lehmann Bros Global Aggregate Index \$A Hedged, (Saloman Smith Barney World Government Bond Index prior to 2003). Property Securities: S&P/ASX 300 Property Accumulation Index (ASX Property Trust Accumulation Index prior to 31 March 2000). The diversified portfolios are hypothetical only and are calculated by a weighted average of the asset class index returns shown in accordance to the following asset allocations. Balanced Portfolio Consists of: 32% Australian Shares, 25% Australian Bonds, 5% Cash, 15% International Shares, 15% International Shares \$A Hedged, 8% Property Securities.

## Rebalancing

When you invest, you and your financial adviser will work out a mix of investments designed to achieve your objectives, also known as your asset allocation. For example, a simple asset allocation for someone who is investing for the long-term and wants to increase their capital may look like this: 70 per cent in growth investments (such as shares and property) and 30 per cent in income-producing investments (such as bonds and cash).

As time goes by, and markets experience their regular ups and downs, your investment portfolio will make gains in some areas and losses in others, and your asset allocation will be disrupted. To ensure you are staying true to your objectives and tolerance for risk, it is necessary to rebalance your investments back to your original allocation. This is done by selling some of the investments that have been high performers and buying more of the lower performing investments, or by buying more of the lower performing investments. Either method will bring the balance back.

Why sell higher performing assets to buy lower performing ones? It seems crazy! In fact, disciplined rebalancing is an excellent long-term strategy for managing risk because it reinforces the 'buy low, sell high' principle. Restoring asset allocations to the original targets not only locks in profits in up markets, but protects your portfolio in a down market.

Furthermore, it consistently aligns your investment portfolio with your stated objectives and prevents you from assuming more risk than intended through market fluctuations.

## Invest on a regular basis over time

Making investments at a slow and steady rate over time (for instance, monthly), no matter what the markets are doing, is a common way to remove market timing risk and enhance long term returns. Say, for example, you adopt the practice of investing \$500 a month into your investment portfolio by direct debit. Not only are you eliminating the emotional aspect of investing, over time you will reduce the average cost of the investments you are buying. How? When market prices are falling your monthly \$500 will buy

more units in a fund, when prices are rising you'll get less units. Over time, the average price per unit that you've paid will be lower than the average unit price for that period.

That's smart investing. And most Australians already engage in this practice without even realising it; by contributing 9 per cent of their pay into superannuation at regular intervals.

### Patience

Successful investors need patience. Your adviser can help you develop a risk strategy that will carry you through volatile times. The longer your time horizon, the more risk you can tolerate in your portfolio. A long-term well-diversified investment strategy can stabilise risk and help you reach your investment goals.

Just look at the sharemarket as an example. Russell research shows that very high sharemarket returns occur in spikes over short periods. Sharp losses are the same. The effect of sharp losses on your investment value disappears almost completely over five-year holding periods and it vanishes over 10-year holding periods. The message: perhaps the best way to reduce risk – invest for the long-term.

**Your financial adviser can answer your questions on risk and investing. Alternatively, for further information you can access Russell's range of Fact Sheets and other material, which are available on [russell.com.au](http://russell.com.au)**