smart Monday

Understanding investment risk

Risk is an inevitable part of investing. Even money sitting in the bank isn't entirely without risk. The challenge for investors is not to eliminate risk, but to understand it and decide how much risk to accept for a certain level of return. All investors face a number of investment risks. Your attitude to these risks will determine what type of an investor you are (your risk profile) and what type of assets you'll invest in.

Let's consider four main types of investment risk

Market risk

Why do some people steer clear of the share market? Usually, it's because of the risk that they might lose money if the market falls. But it's this very market risk that has allowed growth investments (typically defined as shares and property) to outperform more defensive investments like cash and fixed interest over the longer term (seven years plus).

Fluctuating returns can be unsettling over the short term but if you have a longer-term investment horizon, shares and property may give you a better opportunity for capital growth. Of course, there's no guarantee that past performance will be repeated in the future.

Inflation risk

To avoid the risk of losing money in the share market, many people simply put their savings in the bank. But opting for the short-term security of cash in the bank exposes the investor to inflation risk. Inflation risk is the chance that the value of your money won't keep pace with inflation. Inflation is broadly defined as rising prices and if your investment earnings don't rise by at least the same rate, then your money will steadily lose value. Over the long-term, the return from growth assets such as shares and property has beaten inflation by a wide margin.

Interest rate risk

Interest rate risk refers to fluctuations in the cost of borrowing, as well as the danger that your investment will lose value because it has a fixed rate of return that will not change if interest rates rise. Fixed rate investments such as bank accounts and term deposits give you the benefit of certainty, but they can be costly if interest rates rise and you are locked in to a lower rate. Over time, this can make a significant difference to your earnings.

Liquidity risk

Liquidity risk is the risk that an asset cannot be readily sold at a reasonable price (ie the asset is illiquid). Some assets (including direct property and some alternative investments) are, by their nature, illiquid. Other assets can become illiquid because of extreme market conditions.

Investment risk can be simply defined as receiving a return that is different to what you expected. In other words, investment risk is all about fluctuations or volatility in returns.

Managing investment risk

All investments carry some form of risk and although you can't completely eliminate risk (nor should you) there are ways to manage it.

Diversify your investments

Spreading or diversifying your money across different asset classes and different industries is a proven way to manage investment risk. Diversification takes a middle road through the highs and lows of market performance, allowing your money to grow consistently with fewer fluctuations along the way. By spreading your investments across different asset classes (eg shares, property, fixed interest and cash) and different industries (eg retail, banking, mining, etc) you may be able to minimise the impact of poor performance in one particular class or industry.

smart Monday

Managing investment risk (continued)

Invest for growth

Putting your money in a safe investment like a bank account might seem sensible, but remember that inflation is a real threat to the real value of your money. Protecting the purchasing power of your capital means earning long-term returns in excess of inflation. There is a real danger that a bank account won't do this. Reducing inflation risk may require you to invest at least some of your money in growth assets. Historically, growth assets have offered higher returns than defensive assets (cash and fixed interest), and with the power of compound interest working in your favour, just a few percentage points difference in performance can make a huge difference to your long-term returns.

Use time to your advantage

Generally speaking, the longer your investment time horizon, the more risk you can accept. So, theoretically at least, the longer your investment timeframe, the more money you can allocate to growth assets such as property and shares. Even though growth assets carry a greater risk of volatile (and even negative) returns, over the long term, they usually offer the best potential for capital growth.

Understand your risk profile

The cardinal rule for successful investing is to understand what you're investing in. Putting money in riskier investments, like futures, isn't necessarily a bad strategy—as long as you understand the risks.
On the other hand, putting money into a low-risk investment like cash isn't necessarily a safe strategy if you need your money to grow faster than the rate of inflation. That's why understanding your attitude to risk is so important.

Consider financial advice

Making the right investment decisions isn't easy, particularly when you take the complex nature of Australia's superannuation system into account. A professional financial adviser can evaluate your current financial position, help you set realistic investment objectives, consider your investor profile and investment preferences, and prepare a financial plan tailored to your needs. If you don't have an adviser, call us on 1300 880 588 or email enquiries@smartmonday.com.au to ask about the advice services you can access through your membership.

Contact us

E. enquiries@smartMonday.com.au
P. 1300 880 588
F. 1300 267 582
W. smartMonday.com.au
M. Reply Paid 1949
Wollongong DC, NSW 2500

It all adds up

Done today
Smart easy actions

Positive actions
Grow your wealth

Brighter futures
Someday starts today

The information in this document is general in nature and doesn't take into account your personal needs and objectives. smartMonday is a registered trading name of smartMonday Solutions Limited ABN 48 002 288 646 AFSL 236667, the sponsor of the Smart Future Trust ABN 68 964 712 340 (the fund). The trustee of the fund is Equity Trustees Superannuation Limited ABN 50 055 641 757 AFSL 229757 RSEL 0001458. This document has been prepared by smartMonday on behalf of the trustee. smartMonday products are part of the fund. The Target Market Determinations for smartMonday products are available at smartmonday.com.au/governance. smartMonday and the trustee take no responsibility for you acting on the information provided. Any decision that you make is at your own risk.

© 2022 smartMonday Solutions Limited