Table of Contents

Contents

[Appendix 2: Portfolio Risk & Return 2](#_Toc25238220)

[Investment Risk 2](#_Toc25238221)

[The Investment Asset Classes 2](#_Toc25238222)

[Your Risk Profile 4](#_Toc25238223)

[Reducing Risk 4](#_Toc25238224)

[The Risk/Return Trade Off 5](#_Toc25238225)

* Not required for Risk Only SoA’s.

# Appendix 2: Portfolio Risk & Return

## Investment Risk

Every investment entails a degree of risk. The larger the potential return on any investment, generally the higher the risk it has. This means the greater the chance of large fluctuations in its value over time - from significant gains to possibly the loss of some or all of your initial investment.

If your investment is classed as ‘low risk’ it means that its returns will be lower, but the risk is less. However, if the return of the investment is lower than the inflation rate, the buying power of your money will also decrease. Even ‘low risk’ investments carry a significant degree of risk.

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Increasing potential for capital growth** | | |  | | |
| Conservative | Moderately Conservative | Balanced | | Growth | High Growth  Or  Aggressive |
| **Increasing volatility of returns** | | |  | | |

Timing is also a risk when you have to sell an investment. The market could be in a downturn, so you won't get the best price. Similarly, you may sell your investment too early because you have lost confidence in it and then if the market improves you could lose out. Everyone’s tolerance of risk is different, and it will vary depending on your stage in life, as well as your circumstances.

## The Investment Asset Classes

The major asset classes that make up an investment portfolio are Cash and Fixed Interest (collectively referred to as Income assets) and Shares and Property (known as Growth assets).

The following provides a brief overview of each of these major asset classes:

|  |  |  |
| --- | --- | --- |
| Asset Classes | | |
| Income Assets | Cash | Cash is considered a safe investment class, as your money is readily accessible and there is a very low risk of capital loss. The cost of this peace of mind is of course the lower return. The risk of investing in cash is where the after tax return is less than the rate of inflation so that you are effectively losing money. |
| Fixed interest | Fixed interest investments have similar characteristics to cash, with a potential for a low level of capital loss, but not necessarily the same ready access. These are characterised as ‘conservative’ investments because of the low risk of loss, but the trade-off is a lower return on your investment. Note that where interest rates rise rapidly, fixed interest investments can generate capital losses. |
| Growth Assets | Property | Property investments have potential for a higher long term return, and can provide a combination of income and capital growth. The risk with property investments is mostly in the cyclical nature of property markets, which is why most property investments need to be held over a period of at least 5 years. |
| Shares | Shares can provide both dividend income (and the associated benefits of franking credits) as well as capital growth, where the share price increases. It is generally accepted that over the longer term (5 – 7 years plus) shares will outperform other asset classes. However over the shorter term, the value of shares can fluctuate significantly. |

The following table compares the returns of each of the asset classes, and demonstrates the volatility of returns. Whilst the makeup and definition of asset classes may vary with the introduction of increasingly sophisticated products, the following table uses Vanguard consistent major asset classes.

|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **Financial Year total returns % for the major asset classes** | | | | | | | | | |
| **Year to 30 June** | **Cash** | **Bonds** | | **Property** | | **Shares** | | | |
| **Australian** | **Internat’l (Hedged) 1** | **Australian Listed** | **Internat’l Listed 2** | **Australian** | **Internat’l** | **Internat’l (Hedged) 3** | **US** |
| **1990** | 18.5 | 17.8 | 13.1 | 15.2 |  | 4.1 | 1.9 | 5.3 | 11.5 |
| **1991** | 13.5 | 22.4 | 15.3 | 7.7 | -15.9 | 5.9 | -2 | -5.8 | 10.3 |
| **1992** | 9 | 22 | 15.8 | 14.7 | 6.9 | 13.3 | 7.1 | -3 | 16.3 |
| **1993** | 5.9 | 13.9 | 14.7 | 17.1 | 28.3 | 9.9 | 31.8 | 17.3 | 26.6 |
| **1994** | 4.9 | -1.1 | 2.1 | 9.8 | 8.4 | 18.5 | 0 | 6.7 | -6.5 |
| **1995** | 7.1 | 11.9 | 13.1 | 7.9 | 7.5 | 5.7 | 14.2 | 3.7 | 30 |
| **1996** | 7.8 | 9.5 | 11.2 | 3.6 | 2.4 | 15.8 | 6.7 | 27.7 | 12.9 |
| **1997** | 6.8 | 16.8 | 12.1 | 28.5 | 35.7 | 26.6 | 28.6 | 26 | 42.6 |
| **1998** | 5.1 | 10.9 | 11 | 10 | 25 | 1.6 | 42.2 | 22.1 | 58.2 |
| **1999** | 5 | 3.3 | 5.5 | 4.3 | -6.8 | 15.3 | 8.2 | 15.9 | 14.2 |
| **2000** | 5.6 | 6.2 | 5 | 12.1 | 14.1 | 13.7 | 23.8 | 12.6 | 18.2 |
| **2001** | 6.1 | 7.4 | 9 | 14.1 | 38.2 | 8.8 | -6 | -16 | 0.5 |
| **2002** | 4.7 | 6.2 | 8 | 15.5 | 7.5 | -4.5 | -23.5 | -19.3 | -26.3 |
| **2003** | 5 | 9.8 | 12.2 | 12.1 | -5.2 | -1.1 | -18.5 | -6.2 | -15.2 |
| **2004** | 5.3 | 2.3 | 3.5 | 17.2 | 28.7 | 22.4 | 19.4 | 20.2 | 15.4 |
| **2005** | 5.6 | 7.8 | 12.3 | 18.1 | 21.2 | 24.7 | 0.1 | 9.8 | -4.1 |
| **2006** | 5.8 | 3.4 | 1.2 | 18 | 24.2 | 24.2 | 19.9 | 15 | 11.6 |
| **2007** | 6.4 | 4 | 5.2 | 25.9 | 3 | 30.3 | 7.8 | 21.4 | 5.6 |
| **2008** | 7.4 | 4.4 | 8.6 | -36.3 | -28.6 | -12.1 | -21.3 | -15.7 | -23.4 |
| **2009** | 5.5 | 10.8 | 11.5 | -42.3 | -31.2 | -22.1 | -16.3 | -26.6 | -12.5 |
| **2010** | 3.9 | 7.9 | 9.3 | 20.4 | 31.3 | 13.8 | 5.2 | 11.5 | 8.9 |
| **2011** | 5 | 5.5 | 5.7 | 5.8 | 9.2 | 12.2 | 2.7 | 22.3 | 3.7 |
| **2012** | 4.7 | 12.4 | 11.9 | 11 | 7.5 | -7 | -0.5 | -2.1 | 11.1 |
| **2013** | 3.3 | 2.8 | 4.4 | 24.2 | 24.3 | 20.7 | 33.1 | 21.3 | 32.5 |
| **2014** | 2.7 | 6.1 | 7.2 | 11.1 | 11.8 | 17.6 | 20.4 | 21.9 | 22.7 |
| **2015** | 2.6 | 5.6 | 6.3 | 20.3 | 23.1 | 5.7 | 25.2 | 8.5 | 31.8 |
| **2016** | 2.2 | 7 | 10.8 | 24.6 | 20.4 | 2 | 0.4 | -2.7 | 7.5 |
| **2017** | 1.8 | 0.2 | -1 | -6.3 | -4.8 | 13.1 | 14.7 | 18.9 | 13.8 |
| **2018** | 1.8 | 3.1 | 2.5 | 13 | 9 | 13.7 | 15.4 | 10.8 | 19 |
| **2019** | 2.0 | 9.6 | 7.0 | 19.3 | 13.5 | 11.0 | 11.9 | 6.6 | 16.3 |
| **Average** | 5.7 | 8.3 | 8.5 | 10.6 | 10.6 | 10.0 | 8.4 | 7.6 | 11.8 |
| **Best\*** | 18.5 (1) | 22.4 (3) | 15.8 (3) | 28.5 (3) | 38.2 (4) | 30.3 (3) | 42.2 (2) | 27.7 (5) | 57.5 (6) |
| **Worst\*** | 1.8 (7) | -1.1 (2) | -1.0 (2) | -42.3 (3) | -31.2 (4) | -22.1 (2) | -23.5 (3) | -26.6 (4) | -25.8 (3) |
| \* *The figure in brackets after Best and Worst figures is the number of times each asset class was the Best / Worst performer during the financial years shown in the table.* | | | | | | | | | |
| *Source: Andex Charts Pty. Ltd.* | | | | | | | | | |
| *Notes:* ***1****. Index prior to 30 June 2008 is the Citigroup World Government Bond Index AUD hedged, from 30 June 2008 the index is the Barclays Global Treasury Index AUD hedged (previously Lehman Global Treasury Index AUD hedged).* ***2****. Index prior to 1 May 2013 is the UBS Global Real Estate Investors Index ex Australia with net dividends reinvested, from May 2013 the index is the FTSE EPRA/NAREIT Developed ex AUS Rental Index with net dividends reinvested.* ***3****. MSCI World ex-Australia Net Total Return Index (Local Currency) represents a continuously hedged portfolio without any impact from foreign exchange fluctuations.* ***Past performance is not an indicator of future performance.*** | | | | | | | | | |

## Your Risk Profile

An integral part of developing investment strategies and recommendations that you feel comfortable with involves determining your attitude to risk versus return. This is referred to as your risk profile. Before making an investment decision, it is important that you are comfortable with, and understand the risks associated with investments.

Put simply, the relationship between risk and return is that where you take a low amount of risk in investing, you can also expect a low return. Conversely, investments that offer higher returns will generally also be ‘riskier’ in the sense that they will be subject to greater volatility (variation in value) particularly over the short-term.

In order to achieve an investment that offers a level of return that you desire, at a level of risk that you are comfortable with, it is important that we determine your risk profile. In determining your 'risk profile', we considered:

* The purpose of investment
* Your investment timeframe
* Your personal preferences for risk
* Your need for income versus growth

Your risk profile is a measure of how comfortable you are investing your funds across each of the asset classes. The combination of these asset classes provides us with an asset allocation that will be used to determine an appropriate investment strategy for you. There are various types of risk profiles, differentiated by their overall allocation to income and growth assets.

Most investors regard risk as the potential to suffer a loss of capital during the term of the investment. Adopting the above investment risk profile means that you have understood and accepted the potential risk of negative returns across investments within your portfolio.

If you feel the profile outlined earlier in this advice, does not reflect your attitude to investing, it is important we have further discussions before you implement our advice.

## Reducing Risk

If reading information about risks leads you to the conclusion you don't want to put all your money into the one investment but instead several, then you've started to think about diversification.

Diversification is when you divide your investments into different areas to reduce the overall level of risk. Like the truism: ‘Don’t put all your eggs in one basket’, diversification is a fundamental aspect of investing well.

For example, a balanced investment portfolio can include a range of high risk, moderate risk and low risk investments such as property, shares, managed funds, and other investments. By implementing this strategy of diversification, you have employed one of the best strategies to reduce risk.

Risk Factors

Some of the issues that you need to be aware of when investing include:

* The value of investments can fall. Therefore your investment time frame must allow for fluctuations.
* The amount of income generated from investments can fluctuate, or fall. This is important if you will be relying on the income to meet your future income needs.
* The value of the actual investments may not keep pace with inflation - as this will mean that the future purchasing power of a portfolio is reduced. When allocating a portion of the overall portfolio into fixed interest investments, for example, this needs to be considered.

Types of Risk

Some of the factors that influence volatility and returns are investor sentiment, general economic conditions such as changes in interest rates and inflation, rates of growth of the domestic and world economies, and political events. Below is a summary of the major potential risks of investing.

* **Company or share risk:** involves the chance of a specific share or security falling in value due to unexpected changes in the company’s internal operations or environment. An example of this might be the impact of a new competitor on an industry.
* **Credit risk:** involves the risk that a borrower may default on interest or principal repayments. This risk applies to those companies or individuals that invest in debt securities (i.e. fixed interest investments), particularly if they are unsecured, such as unsecured notes.
* **Currency risk:** involves the risk that foreign currencies will fall in value relative to the Australian dollar, which can have a negative impact on investment returns. This risk applies to those that invest in international share or bond markets without fully hedging currency risk.
* **Environmental risk:** involves investments in food, timber, and production where environmental risks such as drought, frost, wind, hail, fire, insects, pests and disease can affect your investment.
* **Fund manager risk:** involves the risk that there may be changes to a fund manager, such as loss of significant staff, or that a fund manager may not apply their stated investment philosophy, or other changes may occur that affect your investment.
* **Horizon risk:** That the investment will not perform as expected within the time frame or investment horizon of the individual investor.
* **Inflation risk:** Also known as purchasing power risk, that the real return of an investment is lower than expected when inflation is taken into consideration. It involves the risk that inflation may exceed the return on your individual asset.
* **Insurance risk:** involves the risk that you may not have a sufficient amount of insurance cover, or that the relevant insurance policy excludes cover in some circumstances.
* **Interest rate risk:** changes in interest rates can have a positive or negative impact, directly or indirectly, on investment value or returns – for example, the cost of a company’s borrowing can decrease or increase.
* **Investment risk:** that the actual investment returns are different than expectations. This is the risk that a chosen investment performs poorly, and does not fulfil its expectations in helping the client to achieve financial goals.
* **Legislation risk:** changes are frequently made to superannuation and tax law that may affect access to or the value of your investment. For example, the changes to superannuation announced in the 2006 budget have abolished tax on superannuation benefits for those over 60, abolished Reasonable Benefit Limits and imposed caps on contributions.
* **Liquidity risk:** involves the risk of not being able to withdraw your investment at short notice.
* **Longevity risk:** That you outlive your personal retirement savings and will then need to rely on government welfare such as Centrelink.
* **Market risk:** economic, technological, political or legal conditions, and even market sentiment, can (and do) change. This can mean that changes in the value of investment markets can affect the value of your investments. The state of the property market will also affect listed property securities.
* **Mismatch risk:** That the product or strategy does not meet your needs or objectives. If you feel that this is the case we strongly advice that you discuss this with the adviser and not proceed with the financial plan unless you are 100% happy with the investment recommendations.

## The Risk/Return Trade Off

One of the central concepts of investment theory is that there is a positive relationship between the level of risk of an investment and its expected level of return – i.e. the higher the risk the higher the expected return, and vice versa. Although logically most investors would prefer low risk, the risk/return trade off would limit the potential for higher returns.

* Although some asset classes (particularly shares and property) can demonstrate significant volatility over the short term, history has shown that over the long term these fluctuations can be smoothed out and higher returns can be generated by implementing two main strategies: diversifying your funds across and within a range of different investments, and recognising that different investments have different time frames. **You can include as much education and supporting information as you wish.**