Investment Risk

BALLINGERS
FINANCIAL PLANNING

Prepared by: Stephen Ballinger on 30 July 2010

What is risk?

Before you consider your investment strategy, it is important that you understand the risks that can affect your investments. All investments are subject to risk. This means that you can lose money on your investments or that they may not meet your objectives, such as growth in the value of your investments or the expected return from your investments.

What risks affect your investments?

The main risks which affect all investments are:

Market risk

Investment returns are influenced by the performance of the market as a whole. This means that your investments can be affected by things like changes in interest rates, investor sentiment and global events, depending on which markets or asset classes you invest in.

Security and investment-specific risk

Within each asset class, individual securities like mortgages, shares, fixed interest securities or hybrid securities can be affected by risks that are specific to that investment or that security. For example, the value of a company's shares can be influenced by changes in company management, its business environment or profitability. These risks can also impact on the company's ability to repay its debt.

Management risk

For managed funds, an investment manager manages your investments on your behalf. There is a risk that the investment manager will make decisions that adversely affect the fund's performance.

Liquidity risk

Liquidity risk refers to the difficulty in selling an asset for cash quickly without an adverse impact on the price received. Assets such as shares in large listed companies are generally considered liquid, while 'real' assets such as direct property and infrastructure are generally considered illiquid. Under abnormal or difficult market conditions some normally liquid assets may become illiquid, restricting the ability to sell them.

Counterparty risk

This is the risk that a party to a transaction such as a swap, foreign currency forward or stock lending fails to meet its obligations such as delivering a borrowed security or settling obligations under a financial contract.

Legal and regulatory risk

This is the risk that any change in taxation, corporate or other relevant laws, regulations or rules may adversely affect your investment.

Income risk

In some circumstances, the income or rate of distribution payments may vary or you may not receive a payment. For example a number of companies suspended payment of dividends in 2008 and 2009 in order to conserve cash during the economic downturn. Managed funds generally only make distributions of income if the fund has generated taxable income. There are times when this does not happen. A good example of this has been

Platinum International in the 2009/10 financial year when it earned 12% on investments for the year but there was no taxable income to distribute so no income was paid to investors.

Option-specific risks

Risks that are specific to some particular investment options are:

Currency risk

Investments in global markets or securities which are denominated in foreign currencies give rise to foreign currency exposure. This means that the Australian dollar value of these investments may vary depending on changes in the exchange rate. Some companies and investment managers may use currency hedging, which involves reducing or aiming to remove the impact of currency movements on the value of the investment.

Derivatives risk

Derivatives are contracts between two parties that usually derive their value from the price of a physical asset or market index. They can be used to manage certain risks in investment portfolios or as part of an investment strategy; however, they can also increase other risks in a portfolio or expose a portfolio to additional risks.

Risks include: the possibility that the derivative position is difficult or costly to reverse; that there is an adverse movement in the asset or index underlying the derivative; or that the parties do not perform their obligations under the contract.

In general, investment managers may use derivatives to:

- protect against changes in the market value of existing investments
- achieve a desired investment position without buying or selling the underlying asset
- gear a portfolio
- manage actual or anticipated interest rate and credit risk
- alter the risk profile of the portfolio or the various investment positions
- manage currency risk.

As a financial instrument, derivatives are valued regularly and movements in the value of the underlying asset or index should be reflected in the value of the derivative.

Credit risk

Credit risk refers to the risk that a party to a credit transaction fails to meet its obligations, such as defaulting under a mortgage, a mortgage backed security, a hybrid security, a fixed interest security or a derivative contract. This creates an exposure to underlying borrowers and the financial condition of issuers of these securities.

Investment managers generally endeavour to manage counterparty credit risk through the following processes:

- reviewing overall counterparty credit risk, the nature of lending principles and arrangements, the availability and adequacy of security where relevant
- applying stringent credit risk management policies and prudent valuation policies
- managing and/or limiting specific counterparty credit risk to particular counterparties, sectors and geographic locations.

Prepared by: Stephen Ballinger on 30 July 2010

Term deposit risk

Specific risks apply to investments in term deposits:

- Market risk – the interest rate applicable to a term deposit is set for a fixed period of time at the time the term deposit is established. If interest rates rise during that time, the investor will miss out on that increase until the term deposit matures. Conversely, if interest rates fall during the term, the investor will be better off but will have to accept a lower interest rate on maturity.
- Early withdrawal risk – most term deposit providers will only allow early withdrawal subject to some kind of penalty. This can mean that the interest rate ends up being much lower than the rate agreed to at the time the term deposit was taken out.

Gearing risk

Gearing involves borrowing money to magnify the potential gains however gearing magnifies both gains and losses, and investors in geared investments will face larger fluctuations in the value of their investments compared with a comparable un-geared portfolio. A geared investment will produce lower returns than a comparable un-geared portfolio when the cost of borrowing exceeds the return on the un-geared investment (ignoring the effects of franking credits). In extreme market conditions, such as October 2008, a rapid fall in the value of investments may result in losing all of your capital.

Short selling risk

Short selling means selling a security that the investor does not own to try and profit from a decrease in the value of the security. This is generally done by borrowing the security from another party to make the sale. The short sale of a security can greatly increase the risk of loss, as losses on a short position are not limited to the purchased value of the security.

Short selling strategies involve additional risks such as:

- Liquidity risk: in certain market conditions, an investor may not be able to reverse a short position because the security it needs to buy may not be available for purchase in a reasonable timeframe or at all. In this event losses may be magnified.
- Leverage risk: whilst short selling can reduce risk, it is also possible for long positions and short positions to both lose money at the same time.
- Prime broker risk: when short selling is employed, the assets of the investor are generally held by the prime broker (which provides the broking, stock lending and other services). As part of this arrangement, assets may be used by or transferred to the prime broker and there is a risk that the prime broker does not return equivalent assets or value to the option (for example, because of insolvency). This would have a substantial negative impact on the value of your investment. This risk is managed by having arrangements with large, well established and globally operating prime brokers.

If an option uses short selling, this is detailed in the relevant PDS.

Emerging markets risk

Due to the nature of the investments in emerging markets, there is an increased risk that the political and/or legal framework may change and adversely impact your investments. This could include the ability to sell assets.

Managed funds that invest in global markets and companies with foreign operations may have exposure to emerging markets.

Prepared by: Stephen Ballinger on 30 July 2010

Is there any other way you can manage investment risk?

An important way that can help you reduce investment risk is by spreading your money across different investments. This approach is called diversification. This can be done in three ways:

1. Within each asset class - investing in a range of securities within an asset class means that returns will generally be less dependent on the performance of any single security. This may reduce the overall security-specific risk across your portfolio.
2. Across asset classes - investing in a range of asset classes means the Impact of ups and downs in any single asset class or market can be reduced. That is, you can spread your exposure to different markets.
3. Across investment styles - different investment managers adopt different styles like 'value' or 'growth', and these styles can perform differently at different times. Investing in a portfolio with a mix of investment managers can help you smooth out any performance variations more effectively. That is, manager risk may be reduced.

Your adviser can help you understand investment risk and design an investment strategy for you.

Are there any other risks you should be aware of?

When investing, there is the possibility that your investment goals will not be met. This can happen because of the risks discussed previously. It can also happen if your investment strategy is not aligned to your objectives.

Range of returns from the main asset classes

Different Investments perform differently ever time. Investments that have produced higher returns over the longer term have also tended to produce a wider range of returns. These investments are generally described as more risky, as there is a higher chance of losing money, but they can also give you a better chance of achieving your long-term objectives.

Investments that have produced more stable returns are considered less risky, but they may not provide sufficient long-term returns for you to achieve your long-term goals. Selecting the investments that best match your investment needs and timeframe is crucial in managing this risk.

How should you determine your investment timeframe?

Your adviser can help you determine your investment timeframe.

If you are mainly concerned about protecting your capital over a relatively short period of time, then a secure, cash-based investment may be the most suitable option. However, if you want the value of your investment to increase over a longer period, then growth assets like shares and property are likely to be included in your investment portfolio.

You should regularly review your investment decision with your financial adviser because your investment needs or market conditions may change ever time.

Investment Risk

BALLINGERS
FINANCIAL PLANNING

Prepared by: Stephen Ballinger on 30 July 2010

What are the main asset classes?

Risk	***Asset***	***Description***
Low	Cash	Cash generally refers to investments in bank bills and similar securities which have a short investment timeframe. Cash investments generally provide a stable return, with low potential for capital loss
Low to Medium	Fixed interest	Fixed interest securities, such as bonds, generally operate in the same way as loans. You pay cash for the bond and in return you receive a regular interest payment from the bond issuer for an agreed period of time. The value of the bond can fluctuate based on interest rate movements. When the bond matures, the loan is repaid in cash. Historically, bonds have provided a more consistent but lower return than shares.
Medium to High	Property	Property generally involves buying a property directly or investing In property securities. Each property security holds real property investments in sectors such as office, industrial and retail. Property securities are generally listed on a stock exchange and are bought and sold like shares. Historically, property investments have been less volatile than shares.
High	Shares	Shares represent a part ownership of a company and are generally bought and sold on a stock exchange. Shares are generally considered to be more risky than the other asset classes because their value tends to fluctuate more than that of other asset classes. However, over the longer term they have tended to outperform the other asset classes.