Key Investment Concepts

Risk and return

Aon Hewitt Financial Education Series

People think of financial risk as the chance of losing money. However, in the investment world, “risk” is considered to be the difference between expectations and results: when the actual returns you make from an investment are different from the returns you expected to make.

Every investment has its own sources of return (*how* it makes money) and set of risks (things that could *prevent* it from making money).

All individual investments are risky in some way. There are different types of investment risks that vary in number and significance across investments. Some investments have only a few risk factors, and some investments have a combination of many risk factors. Some risks are relatively tolerable in isolation, while some, such as bankruptcy, are potentially severe.

What is the risk/return trade-off?

The “risk/return trade-off” is an important investment concept. What it boils down to is that the more risk an investor takes on, the higher the return they expect from the investment to reward them for taking that risk. Theoretically, the higher the risk, the higher the expected return.

The returns from some types of investments are perceived to be more stable and predictable (“less risky”) than others. Investments that are perceived to be lower risk are typically income-focused assets such as cash and fixed interest (bonds) and have lower expected returns. “Riskier” investments such as shares and property have the greatest potential for capital growth but tend to be more volatile over the short term and have a higher chance of losing money.

The risk/return trade-off is used to help guide the appropriate asset allocation for you. As an investor, you need to balance the goals of growing your wealth and protecting your wealth. Taking on either too much or too little risk can prevent you from achieving your goals. You will want to strike the right balance for you in selecting the mix of assets that have a reasonable overall chance of achieving your expected return over your time horizon, with a level of volatility and chance of capital loss that you feel comfortable accepting. Interim fluctuations can be expected over shorter time periods, so it is important to remain focused on your longer-term time horizon and goals.

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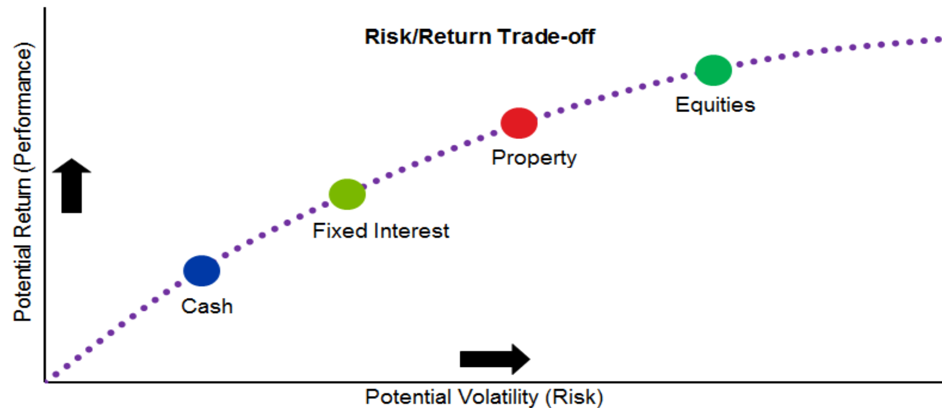
The higher the expected risk, the higher the expected return



One of the ways to manage investment risk is through diversification, which involves spreading your investments among different types of assets. Diversification reduces the impact that risky individual investments have on your overall return. Diversifying across different types of assets achieves the "strategic asset allocation" that has the overall risk and return characteristics you are willing and able to target over your desired timeframe.

For more information on diversification, please refer to the 'Asset Classes and Diversification' fact sheet under the Key Investment Concepts Financial Education Series.

Investment risk from an investor's perspective

- Making less money than you expect or need
- Losing money, maybe even leaving you with less than what you started with
- Volatility – the value of your investment unpredictably moves up and down, which is an uncomfortable feeling for some investors
- Your investment could be performing poorly right at the time you need to sell it
- The investment you choose earns less than other investments you might have made
- The amounts you make don't keep up with inflation, so it is progressively harder to cover your cost of living
- You run out of time – your investment timeframe might be too short to realistically be able to achieve the results you need

When investment results cannot or do not meet your requirements, you may need to make potentially difficult choices about your retirement plans. Work more. Work longer. Save more. Spend less.

The goal in financial planning is to help you achieve the outcome you want: retiring when and how you choose. The challenge in financial planning is to help you manage these investment risks to help you get there.

Types of Investment Risk

All investments and strategies carry some level of risk. Common sources of risk include:

Type	Definition
Business Risk	A company may suffer losses or profits which are less than expected as a result of adverse circumstances in the company's activities, such as trade restrictions or a worldwide recession.
Country Risk	A collection of risks associated with investing in a foreign country. These risks include political risk, exchange rate risk, economic risk, sovereign risk and transfer risk, which is the risk of capital being locked up or frozen by Government action. Country risk varies from one country to the next. Some countries have high enough risk to discourage much foreign investment.
Credit (Default) Risk	The possibility that an institution holding your capital may fail to pay interest or return on your capital invested.
Currency Risk	When you invest in a foreign country and the exchange rate works against you. When investors or companies have assets or business operations across different countries they face currency risk if their positions are not hedged.
Inflation Risk	The possibility that the purchasing power of your money may not keep pace with inflation (e.g. by not investing at all or not investing sufficiently in growth products), and this risk results in a poor real return of your funds invested.
Interest Rate Risk	Changes in interest rates causing an investment in a fixed-income security to decrease or increase in value.
Legislative Risk	A new law or a change in an existing law, such as changes to super and taxation legislation, could have significant impact on your investment.
Liquidity Risk	You may not be able to readily access your funds when you want or need them most if they are invested in illiquid assets or if markets freeze (as they did in the Global Financial Crisis).
Manager Risk	Your investment manager may underperform your expectations or lose their fundamental ability to meet your investment requirements.
Market Risk	Movements in an asset market can cause the value of an investment to either decrease or increase over time.
Re-investment Risk	In fixed income investments, you may have to re-invest maturing funds at a lower rate of interest because interest rates have gone down since your original investment. (This is one reason why cash is not considered risk-free.)
Risk of Not Diversifying	If you put all your investment capital into the one basket (e.g. the share market), a fall in that market will adversely affect all of your capital. Diversification is a deliberate strategy aimed at reducing the impact that volatility in one asset class, sector or market will have on your overall portfolio of assets.
Timing Risk	The possibility that a strategy of trying to time the entry or exit from financial markets can expose you to losses. Timing risk is magnified when investors chase recent performance.
Valuation Risk	If you overpay for an asset, its return potential will be constrained and results won't be what they could be. You may also misjudge downside risk and sell an asset too cheaply.

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