

Investment risk

Whenever you invest, there is a relationship between the return you receive and the risk you are taking to achieve that level of return.

Risk and diversification

There is a relationship between the amount of risk you are willing to take and the potential return you may get on your investment.

In general, investments which potentially earn higher long-term returns (e.g. equities and property) carry higher short-term risk. The rate of return of the investment may vary and also the value of the investment can rise and fall more sharply than other investments.

Typically, investments that potentially earn lower longer term returns (e.g. cash, fixed interest and bonds) are likely to fluctuate less in the short-term.

Factors such as interest and exchange rates, government policy and the state of the domestic and world economies will have an impact on the financial and investment markets and therefore on your investment.

In the case of listed securities such as shares and listed property trusts, other influences include political events and the performance of international share markets. It is also important to note that the returns from listed investments reflect the market forces of supply and demand and investor sentiment.

The principle of diversification is where you spread your investment between more than one asset class. The objective is to achieve more stable investment returns, in other words, the total returns of a diversified portfolio should not fluctuate as much as the returns from investing solely in one asset class. A Fund may diversify further by spreading money across a group of specialist fund managers.

Risks of investing

In general, investment which generate the highest returns tend to have the highest risks. 'Risk' means that returns might be variable (or 'volatile'), and in some instances, part or all of the investment might be lost. Historically, shares have been more volatile than other investments, such as property or fixed interest.

Regardless of what Investment Strategy you choose, the value of your investment can fall as well as rise. Even where your

investment does not fall in value, it may not perform according to your expectations.

Inflation risk

A further risk is inflation. Although an investment may produce a positive return, when we compare this to the increase in the cost of living, we may find that your return hasn't been able to keep up with inflation, effectively reducing your purchasing power. You need to balance risks against returns in order to achieve your investment goals.

Credit risk

Where you invest in debt securities or other debt instruments (such as debentures), these could be subject to default risk. For example, where you buy a Bond that has an interest payable regularly and a capital repayment (the money you get at the end of the period of the Bond), there is a risk that the organisation that issued the Bond (credit issuer) may default on interest payments, the capital repayment, or both.

Interest rate risk

Cash, cash-like securities and debt securities investments are affected by interest rate movements. Capital gains can be earned from debt securities investments where interest rates are falling and capital losses can occur where interest rates are rising. The risk of capital gain or loss tends to increase as the term to maturity of the investment increases.

Liquidity risk

Many investment strategies hold assets which are 'illiquid'. If you invest in illiquid assets, you may not be able to sell the investment at short notice, or you may need to sell your investment at a discount or a loss if you need to 'cash out' quickly. Examples are direct property, absolute return, private equity and non-listed alternative investments. Listed investments can be illiquid where there is not an active market for the securities such as small companies' shares.

To effectively manage the risks of illiquid investments you should diversify across a range of investments and limit your holdings in a potential illiquid investment.

Market risk

General economic conditions both in Australia and elsewhere in the world have an impact on markets. Changes in government policies, interest rates, inflation, technological developments and demographic changes such as the ageing of the population of

Australia all affect investment markets as a whole causing the value of investments to rise and fall. There is no way of accurately predicting what will happen and how these changes will affect the markets.

Asset class risks

Risks for individual asset classes include:

- ▶ **Alternative assets** – Alternative assets can involve exposure to all of the risks which apply to the traditional asset classes. In addition, many alternative assets are illiquid and can also involve the use of derivatives, gearing and short selling.
- ▶ **Australian equities** – Specific risks relating to individual companies include profits and dividends being below expectations, management changes or reassessment of the outlook for the company or industry.
- ▶ **Cash** – It is unlikely that the market value of a cash investment will decline, but longer-term returns are generally lower than other assets.
- ▶ **Debt securities** – Whilst such investments normally pay a set amount of interest income over time, market values can fluctuate. Overall returns over short term periods can be negative. Fixed interest investments are also subject to default risk.
- ▶ **International equities** – Global economic trends, individual country risk factors as well as specific risks relating to individual companies will affect the price. There is also a currency risk unless the investment is hedged. Capital gains may occur when the Australian dollar depreciates against other currencies and capital losses may occur when the Australian dollar appreciates.
- ▶ **Property** – Risks include vacancies, locational factors, unprofitable property development activities, declining property values and realised losses when properties held in a listed entity are sold. Other risks include delays in obtaining required approvals, construction risk, leasing risk and market risk.

Derivatives risk

Derivatives can be used for many purposes, including hedging to protect an asset against market fluctuations, reducing costs of achieving a particular market exposure and maintaining benchmark asset allocations. Risks include:

- ▶ **Price** – Price movements in the market underlying a derivative contract, or in the derivative contract itself have an adverse affect on the derivative position
- ▶ **Leverage** – You may magnify your losses if you create an exposure which is greater than the assets that back the position in that market.
- ▶ **Liquidity** – A derivative position may not be liquid so it can not be reversed.

- ▶ **Default** – The other party does not meet its obligations.

Hedge Funds are often used to reduce overall portfolio risk as they manage investments designed to offset the potential losses of other investments. These funds use a wide range of securities, instruments and strategies to provide a positive return, regardless of the underlying security market movement. Hedge funds have been used to lower the overall volatility of a portfolio.

Short Selling risk

Short selling is a sophisticated technique where a share is sold, for delivery at a later date, in anticipation that its value will decline over the period, and you will be able to buy it back at a cheaper price than you sold it. Of course if the price has gone up you can lose the difference between what you sold it for and what you need to buy it for (plus all the transaction, holding and other costs).

Due to the nature of short selling, the potential loss to the asset may be greater when compared to more traditional purchase and sale transactions. This is because there is risk that the price of the asset sold increases rather than falls.

Currency Risk

Currency Risk arises from the change in value of the Australian dollar against other currencies.

Changes in the value of the Australian dollar or other currencies can have an impact on the value of international equities. For example, international investments may rise in value if the Australian dollar depreciates or decrease in value if the dollar appreciates. Investors often hedge against Currency risk by using current future or forward contracts.

How do I understand and manage my risks?

There are a number of things you can and should do to manage the risks associated with investing in the investment strategies offered:

- ▶ Get professional advice to make sure you choose an investment strategy which suits your investment objectives and your financial situation.
- ▶ Invest for at least the suggested minimum timeframe for the investment strategy.
- ▶ You should also consider the relative risk of your investment strategy. However, remember that investing for the suggested minimum investment timeframe does not eliminate the risk of loss.
- ▶ Regularly review your investments in light of your investment objectives and your financial situation.

Need further information?

If you have any questions about the material covered in this fact sheet, please contact FuturePlus on **1300 883 788** between 9am and 5pm on any business day.

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