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A Guide to Risk Assessment for Investors

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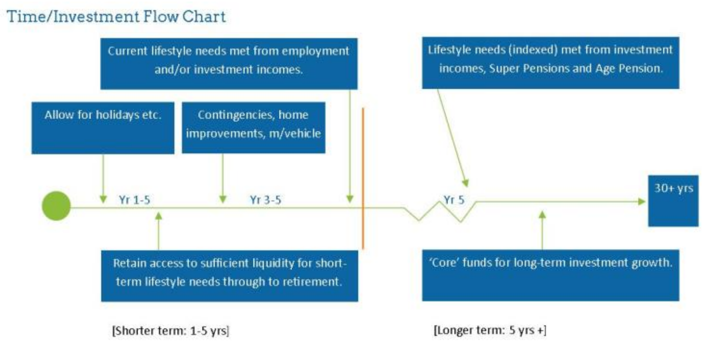
Outlined in this eBook are some pointers around risk management issues and how important it is to re-assess your risk profile.



Investment Time Horizon

An essential component of risk determination and investment planning is influenced by your liquidity requirements in the short-term (1-5 years) together with your need to provide for retirement, hence long term growth in investment values.

Depending on current income and living expenditure requirements, you will need to ensure you retain sufficient surplus funds that can be accessed should the need arise. The remaining funds could be quarantined as 'core' investments (surplus investments to immediate needs), which can be invested in a diversified portfolio of longer term, growth-oriented investments in line with your risk appetite.

This process of quarantining assets into short/long term investments mitigates the prospect of you having to sell growth assets to meet immediate needs too soon after the initial investment (long term investments with a higher risk profile, such as shares, property, etc.). Growth assets traditionally require a 5+ year time horizon to allow industry and market cycles to run their normal course. The higher the risk, the longer the preferred investment time horizon to avoid selling at a possible loss caused by market downturns.

For example, you could segment your investments into short-term liquidity needs, while quarantining core capital in line with your investment time horizon as follows:-

Personal Attitude to Risk and Return Time Horizon

Your personal tolerance to risk is a major determinant in shaping your investment strategy and portfolio structure. Issues such as, need for cash retention, investment time horizon, health, life expectancy, future spending expectations, amount of initial investment capital, preferred investment returns, past exposure to investment products, and other personal issues, all impact on your investment preferences.

A cautious person may develop a conservative approach to investing, hence will have a low tolerance to risk and intuitively a lower expectation of return.

The opposite would be true of an entrepreneurial investor who would have a more speculative, higher risk investment portfolio. In each case, the investor should hold the opinion, the higher the risk, the higher the reward.

Your investment time horizon will also have a significant impact on the nature of investment assets you choose and consequent risks/returns inherent in your investment portfolio. In this regard, it is important to match your spending pattern with investment selections to avoid the prospect of selling growth assets (shares) during a severe market down-turn.

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For example, cash is not a suitable investment of funds to achieve growth over a ten year investment time horizon, just as equities or property are generally unsuited as short term liquid investments for say a 1 year investment period.

Whether you are in the accumulation or retirement phase, your investment capital will never retire and could still have at least a 20+ year investment horizon. This suggests you can take longer term investment decisions for part of your **core** portfolio. Accordingly, you will be able to ‘ride out’ negative market cycles through careful allocation of longer-term investment funds within the major asset classes.

An additional factor, influencing acceptance of risk is your reward expectations. Your expectation of an acceptable investment return, which should provide sufficient income to support living expenses throughout retirement, provides a further element of risk appetite. As mentioned earlier, the generally accepted principle is, ‘the higher the income need, the higher the investment risk’.

It is at this point where you must clearly appreciate the trade-offs between acceptable risk and your desired level of income/growth. These trade-offs will become more evident to you during the process of determining your preferred investment asset allocations vs income/growth needs.

The Importance of Asset Allocation

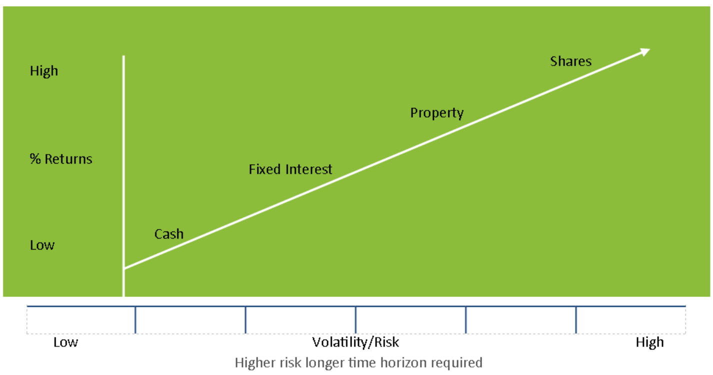
The mix between the major asset classes of Cash, Fixed Interest, Equities and Property investments largely determines portfolio investment risk.

Asset mix (or asset allocation) as the primary determinant in risk, arguably accounts for up to 80% of the inherent risk/volatility in any investment portfolio. By spreading funds over the major asset classes, you reduce volatility/risk associated with a single asset class and therefore reliance on any one asset sector’s performance. The risk of a particular market sector under-performing and causing major damage to your investment portfolio’s value is reduced as you only have a limited amount invested in any one area.

Historically, diversifying investments across all major asset classes spreads risk and enhances the potential for the smoother accumulation of returns.

The other portfolio risk elements are stock selection, which provides a 10% risk factor, while timing of your entry into the investment market accounts for 10% of performance risk.

The graph below illustrates the level of volatility (risk) and return traditionally experienced by the major investment asset classes.



Reference Source: William M Mercer ‘Looking Ahead’ 1999 edition

Asset Quality

As mentioned earlier, depending on your investment time horizon/life expectancy, which for many is 20+ years, it is appropriate to maintain a long-term view on your investment selections. When choosing your investment portfolio, asset quality is a method of controlling and managing your portfolio risk. This is particularly important when investing for the longer-term.

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Consequently, your portfolio will need to be structured to withstand the likelihood of periodic downturns in the financial markets and economy in general over an extended period. An example of asset quality is investing in 'Blue Chip' shares, which represent the top 50 listed industrial companies on the Australian Stock Exchange and historically perform well over time.

The value of a portfolio of high quality, diversified assets, although not insulated from any downturn in market values, which occur from time to time, does provide the best chance of survival during these times. The true test of asset quality/allocation appears during periods of adverse market swings, when total portfolio performance may experience less severe markdowns than a not so well structured investment strategy.

The corollary to this is that the portfolio will also be better placed to participate in the next upswing.

The Inflation Factor

Inflation is often under-estimated as a risk by many investors who tend to focus on risks associated with individual investments in their portfolio. An investor needs to ensure that their savings maintain purchasing power against the continual increase in the cost of goods and services caused by inflation. From a risk perspective, once inflation has eroded the purchasing power of an asset, that amount is lost forever.

For example, a portfolio valued at $100,000 with a 4% pa inflation rate, ensures a risk/loss equal to $4,000 in the first year, unless investment returns exceed this amount.

While inflation is active on the whole portfolio, cash investments are the most obvious assets which are eroded by inflation, i.e. cash can be a risky investment! The impact of inflation on individual investments within a diverse portfolio may represent a fraction of the total portfolio; provided total asset quality is sound, any single diminution in value can be mitigated.

To demonstrate the erosive effects inflation can have on purchasing power, assume savings of $100,000 and examine the effect of 3%-5%-7% pa inflation over 10 & 20 year periods.

Present value of $100,000	3% pa	5% pa	7% pa
In 10 years	$74,409	$61,391	$50,835
In 20 years	$55,368	$37,689	$25,842

The Taxation Factor

Portfolio earnings are derived from a number of sources, i.e. interest, dividends, capital appreciation, currency gains, deferred incomes, etc. The taxation treatment of these earnings also differs.

Diversifying and managing the cashflows and holding period between the various asset classes within your investment portfolio, is a form of tax planning and can produce significant variations in returns and tax liabilities.

For example, by deferring selling assets with capital gains, which might incur a Capital Gains Tax liability, you continue to accrue earnings on the inflated value. Once you sell that asset, you lose a portion to CGT and dilute the residual value of the capital for re-investment. Another example might be receipt of company dividends, which may be received with tax paid (imputation credits) while interest earnings have no tax paid.

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Many investors focus on 'nominal' returns, which only provides a measure of the **change** in dollar value of their portfolio. Nominal returns do not make adjustment for the increase or decrease in **purchasing power** (inflation) of money. To illustrate this, we need to adjust the nominal return to allow for the impact of tax and inflation.

An example is set as follows:-

	Portfolio A	Portfolio B
Nominated Rate of Return	6.0%	12.0%
Return Less Tax At 46.5%	3.21%	6.42%
Less Inflation *	2.0%	8.0%
After Tax Real Return	+1.21%	(1.58%)

* Assumes nominal returns increase by the same amount as inflation (+6.0%) and funds invested in cash.

The above table illustrates that high nominal returns do not automatically translate into an improved purchasing power or lifestyle.

By inference it also highlights the importance of improving tax efficiency via adopting investment strategies including income splitting, tax privileged investments (franked dividends, superannuation), gearing, asset mix or the use of investment structures such as family trusts, etc.

Maintaining Your Strategy through Difficult Times

The conclusion to be drawn from the following tables, is that it is **normal behaviour** for investment markets to experience volatility in returns. Therefore, for an investor with a suitable time horizon and well diversified portfolio of quality assets, **patience** is an important contributor to a successful result.

- **Cash:** RBA Bank Accepted Bills 90 Days
- **Fixed Interest:** 50% UBS Composite 0+ Year TR AUD / 50% BarCap Global Aggregate TR Hdg AUD
- **Property Securities:** S&P/ASX 300 A-REIT TR
- **Australian Shares:** S&P/ASX 200 TR
- **Global Shares:** MSCI World NR AUD

Year (30 June to 30 June)	Cash	Fixed Interest	Property Securities	Australian Shares	Global Shares
Annualised last 20 years	**5.51%**	**8.12%**	**8.75%**	**9.81%**	**6.24%**
1993	5.65%	13.93%	17.46%	9.89%	**31.27%**
1994	4.87%	-0.07%	8.09%	**18.42%**	0.21%
1995	7.15%	12.64%	9.06%	5.69%	**14.04%**
1996	7.49%	9.92%	3.68%	**15.75%**	6.64%
1997	6.29%	14.26%	**29.14%**	26.50%	28.39%
1998	4.97%	10.87%	9.72%	1.64%	**41.48%**
1999	4.89%	4.23%	3.96%	**15.31%**	8.20%
2000	5.58%	5.03%	15.58%	15.43%	**23.56%**
2001	5.78%	9.69%	**13.84%**	9.05%	-5.81%
2002	4.57%	7.42%	**15.09%**	-4.68%	-23.22%
2003	4.82%	11.14%	**12.14%**	-1.71%	-18.25%
2004	5.26%	3.18%	17.12%	**21.49%**	19.28%
2005	5.53%	8.20%	18.36%	**26.29%**	0.57%
2006	5.66%	2.79%	18.05%	**23.88%**	19.92%
2007	6.32%	4.84%	26.26%	**28.59%**	8.21%
2008	**7.28%**	6.15%	-37.60%	-13.35%	-20.94%
2009	4.75%	**10.37%**	-42.05%	-20.10%	-16.28%
2010	4.03%	9.67%	**20.30%**	13.12%	5.47%
2011	4.90%	6.23%	5.85%	**11.71%**	2.96%
2012	4.41%	**11.94%**	10.93%	-6.68%	-0.76%

The above table highlights the calendar year % returns for each asset class over 20 years, highlighting the individual best/worst performing asset class for each year. The table reinforces the notion of exercising **patience** when investing across all asset classes.

The table clearly shows that no particular asset class will perform well all the time, also successive years' performance within the asset class will vary. Again, this supports the importance of diversifying amongst the major asset classes.

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In addition to calendar year % returns, the following chart outlines 'long-term historical **real** (after tax) return' from the major asset classes over the long term (7 – 10 years) while highlighting the potential 'risk of a negative returns' occurring in any given year.

Once again, the importance of the following chart is that the longer your investment horizon, the lower the risk of experiencing a reduced return.

Asset Class		Long-term real return (% pa)	Risk of a Negative Return in any given year (%)				
			1 Yr	3 Yrs	5 Yrs	10 Yrs	20 Yrs
Cash	Australian	0-2	0.0	0.0	0.0	0.0	0.0
	International	0-2	24.0	11.5	6.0	I.5	1.0
Fixed Interest	Australian	1-2	10.3	1.4	0.2	0.0	0.0
	International	1-2	24.6	11.8	6.3	1.5	0.1
Property	Australian	3-7	26.3	12.4	6.8	1.8	0.1
Shares	Australian	5-8	28.2	15.9	9.9	3.4	0.5
	International	5-9	26.6	13.9	8.1	2.4	0.0

Reference Source: 'National Australia Financial Management Ltd'

The conclusion that we can draw from all of the above data is, that it can be expensive to 'keep changing jockeys' by changing your investment strategy in the hope of improving returns, i.e. exiting and entering markets in anticipation of future price movements (this type of approach is better known as taking a 'tactical' position).

Transaction costs including management fees, brokerage, lost revenue from your time 'out' of the market, possible capital gains tax liability and tax on interest earnings while waiting to re-invest funds, etc.; these all add to the cost of changing strategies and place pressure on future returns.

It is 'time in the market' rather than 'market timing' that significantly improves the chances of a successful result in the longer term.

Overall Assessment of Your Risk Profile

Depending on personal risk preferences and your capacity to accept the risk issues outlined above, you may be prepared to vary your risk appetite and accept a differing level of risk in order to improve income/growth prospects for your superannuation/ general investments. You may be happy to accept the trade off between higher risk/higher returns. Depending on all the above mentioned factors, you will be able to quantify your risk appetite along the following risk line.

For example, an investor may presently believe that his/her current portfolio reflects that of a somewhat 'Conservative' investor profile (x) when in fact they may be comfortable with a higher risk factor, i.e. a 'Strongly Balanced' (y) but more growth-oriented investor approach.

A more growth-oriented approach will allow the portfolio to maintain greater capital growth over the longer term, thus improving regular income prospects throughout retirement.

The primary **investment** concerns for the next 5 years may be summarised as follows:-

- Income to keep pace with inflation
- Easy access to your capital
- Easy to manage
- Legal, logical and appropriate tax relief
- Regular income from your investments
- Capital growth to keep pace with inflation

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- Capital stability of investments in the short term
- Future investment capital to fully-fund retirement

For example, if you are very concerned for investment income to keep pace with inflation with appropriate tax relief, however not quite as concerned to achieve capital growth, which effectively supports long-term regular income growth, then some investment strategies could run in conflict with each other.

Additionally, to retain easy access to capital, suggests a preference for cash/fixed interest products, which are not effective against inflation or tax efficient.

At times, investors may need to consider accepting some 'trade-offs' to meet their preferred objectives.

We would assess your concerns are in reasonable harmony as you are **very concerned** for capital growth to keep pace with inflation which supports future income growth, while not requiring excessive liquidity (low risk/return assets). Excessive liquidity does not support 'real' net growth above inflation. However, you are **concerned** with short term volatility/capital stability, consequently asset allocation in the short term is important.

Asset Allocation

The following table outlines conventional wisdom on the various asset allocation **Benchmarks** appropriate for certain investor risk profiles. These are subject to regular review but they do serve as a useful guide for investors:-

	Risk Profile		
Asset Sectors - Benchmark	**Conservative**	**Balanced**	**Aggressive**
Income			
Australian Cash	20%	10%	3%
Australian Fixed Interest	30%	20%	4%
International Fixed Interest	20%	10%	3%
	70%	**40%**	**10%**
Growth			
Australian Shares	17%	35%	48%
International Shares	8%	15%	27%
Listed Property	5%	10%	15%
	30%	**60%**	**90%**
Total	**100%**	**100%**	**100%**

Asset Allocation vs. Asset Allocation Benchmarks

A '**strategic' asset allocation** is primarily concerned with the longer term investment horizon of 5 –10 years or more and takes into account the behavioural habits of the major asset classes over the full investment cycle.

When adopting a strategic approach to asset allocation, it is also important to recognise that asset classes will grow at varying rates causing variances to your agreed allocations. By setting upper and lower limits (trading ranges) around the strategic allocation **benchmarks**, you maintain a disciplined approach to monitoring asset growth to ensure you do not become overly exposed to any particular asset class and create a shift in risk factors contrary to your risk tolerances.

This process helps avoid moments of being caught up in market euphoria by favouring one particular asset class, at the expense of a lesser performing asset, which will return to favour in due course.

The process of constantly referring back to your **benchmarks**, creates a built-in 'buy/sell strategy which requires you to re-weight back to your agreed asset allocation benchmarks and avoid the trap of being caught by rapid changes in market sentiment.

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This process of setting trading ranges is also referred to as the **'tactical'** asset allocation.

Time spent on risk assessment is extremely valuable and is vital in reaching consensus on your preferred portfolio risk and final investment strategy and selections.

If you are uncertain of your preferred risk appetite and investor profile, we encourage you to contact a Pinnacle Advisor who can provide guidance in this area.

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