Understanding investment risk

What is risk?

"A ship is safe in harbour, but that's not what ships are for."

- William G. T. Shedd

As a concept, risk lives in an awkward no man's land between objective science and subjective philosophy – it can mean different things to different people. In terms of investments, risk is the possibility that you lose some of your money. The presumption is that this is a bad thing because it reduces your ability to buy goods and services. Financial risk is broader because it includes not just risk on investments but also the risk that you lose your overall ability to save and accumulate wealth.

We define investment risk as: *The possibility of losing money/wealth in real terms.*

Risk and return

Risk is an ever-present concept when it comes to investing. According to financial theory – as well as common sense – making an excess return on an investment is a reward for taking a risk with your money/wealth. Investing is about taking a series of controlled risks, with an expectation (but never a guarantee) of making some extra return.

How do you measure risk?

Investment risk involves measuring two key things:

⇨ The **probability** of loss - how *often* you can expect to lose.

⇨ The **magnitude** of loss - how *much* you can expect to lose.

The standard way to measure probability and magnitude of loss, albeit indirectly, involves the concept of variance. Variance is a measure of how much the actual return might differ from what you expected and so it serves a useful function as a basic measure of uncertainty.

The journey matters

When you're investing for retirement it's critically important to understand market risk in terms of volatility (the ups and downs), and how it impacts on the overall 'journey' and the outcome. Failing to understand volatility can often become a 'mental trap' for investors and can potentially derail a sound investment plan.

Long-term inflation is often the real risk

When considering the various risks of investing, many people tend to focus on the risk that they may lose money – that your $1,000 investment could potentially only be $900 by next year.

However, the real risk to your savings often comes from inflation.

What is inflation?

Inflation is the rate at which prices increase over time and it reduces the buying power of your money. While inflation won't cause your savings to decrease in value, it does mean you won't be able to buy as much with it.

For example, if you were to put your $1,000 investment under the mattress today and leave it there, at a rate of 2.5% inflation every year, it would only buy you $781 worth of goods ten years' later.

This is why it's important to factor in inflation when you're working out how you'll invest your money, or how much you'll need in retirement.

Managing risk-taking

When an investor thinks about how much risk to take, it is useful to ask these three specific risk questions:

- ⇨ ***How much money can I afford to risk for reward?***
- ⇨ ***How much money can I personally tolerate losing?***
- ⇨ ***How much risk do I need to take?***

Risk-taking activity must start with understanding how much wealth you have and what your savings capability is.

Your Adviser can help you work out the answers to these questions and find appropriate investment solutions.