Understanding investment risk

"The word 'risk' derives from the early Italian risicare, which means 'to dare'. In this sense, risk is a choice rather than a fate"
-Peter L. Bernstein, Against the Gods, The Remarkable Story of Risk

Generally, the 'risk' associated with investments implies the chance of an actual return varying from the expected return. A central idea in finance is the relationship between risk and return. Hence, the more risk you take, the higher the return you should receive since you ought to be compensated for taking an additional risk.

Any investment decision entails some risk. Therefore, when you understand the risks involved in investing, you can make a more informed investment decision by managing these risks.

Risk types

Following are various risks that you will encounter when making an investment.

■ **RISK TYPE 1:** Mismatch risk

– What it means: An investor has chosen investments that are not suitable for his or her circumstances.

■ **RISK TYPE 2:** Inflation risk

– What it means: The risk that the purchasing power of your money maybe eroded by inflation.

■ **RISK TYPE 3:** Interest rate risk

– What it means: Probability that the market interest rates will rise significantly higher than the interest rate earned on your investments.

■ **RISK TYPE 4:** Market risk

– What it means: The possibility of an investor experiencing losses due to the factors that affect the overall performance of the financial markets.

■ **RISK TYPE 5:** Market-timing risk

– What it means: The potential for missing out on beneficial movements in price due to an error in timing.

■ Risk type 6: Risk of poor diversification

– What it means: The poor performance of a small number of asset classes significantly affecting the total portfolio.

■ **RISK TYPE 7:** Currency risk

– What it means: Risk that arises from the change in price of one currency against another.

■ **RISK TYPE 8:** Liquidity risk

– What it means: The risk of not being able to access your money quickly or cheaply when you choose to.

■ **RISK TYPE 9:** Credit risk

– What it means: The risk that the institution you invest with may not meet its obligations (i.e. default on interest payments).

■ **RISK TYPE 10:** Gearing risk

– What it means: Gearing is borrowing to invest and the risk involved in borrowing to invest.

Mismatch risk

An investment plan will help you to decide what you want to achieve from your investment. Therefore, by following a proper plan, you can escape the temptation of investing emotionally or impulsively. It is hard to make rational investment decisions when at one end of the spectrum there are conservative investment options and at the other stocks that are rapidly rising in price.

Poor financial planning can easily result in mismatch risk and the only way to circumvent this is to have an investment plan that fits your objectives and time frame.

Your objectives

The following questions should help you identify what your investment objectives are:

■ **What are you hoping to achieve by investing?**

– To be able to afford a house?

– Pay for your child's education?

– Fund your retirement?

■ **Are you investing for income, capital growth or a combination of the two? You need to select investments that will enable you to achieve those goals.**

Your time frame

You may want to invest for a specific need with a short-term view or perhaps for your retirement with a long-term view. The latter will require that you grow your capital in view of your retirement.

What is given below will help you to avoid mismatch risk by matching your time frame, objectives and investments.

■ **OBJECTIVE 1:** Short term

– Time frame: Less than 12 months

– Investment: Short-term deposits and money

■ **OBJECTIVE 2:** Medium term

– Time frame: At least three years

– Investment: Emphasis on fixed interest - with some cash, longer-term deposits and growth assets

■ **OBJECTIVE 3:** Long term

– Time frame: More than five years

– Investment: Emphasis on growth - shares and property with some access to cash

Inflation risk

Inflation is an increase in the price we pay for goods and services. Inflation can be your greatest enemy. It erodes your returns, increases the interest rates and can lead to poor investment decisions. Inflation can decrease the amount of goods or services you would be able to purchase.

When you decide on the return you expect from your investment and plan an investment strategy, it is important that you take inflation into account. For an instance, an investment that gives a return of 2 percent before inflation in an environment of 3 percent inflation will produce a negative return (−1 percent) when adjusted for inflation.

Therefore, in order to protect your investment from inflation over time, you need to ensure capital growth. While fixed term deposits and savings accounts may generate a regular income, your capital value remains the same. On the other hand, many people choose these investments because they seem safer.

However, if you do not keep pace with inflation, you can lose money. That's why you should include some growth investments like shares and real estate in your medium and long-term investment strategy. These investment options are able to beat inflation more than cash and fixed income investments.

Interest rate risk

Jawaharlal Nehru once said, "The policy of being too cautious is the greatest risk of all."

The risk that arises when the absolute level of interest fluctuates is known as the interest rate risk. Interest rate risk directly affects the values of fixed-income securities. We can take a look at how bond prices get affected by interest rate fluctuations.

If you plan to hold on to the bond, the value will not change just because the interest rates fluctuate. You will still get the amount as promised. The bond prices go up when the interest rates are low and go down when the interest rates are high. Bonds are attractive additions to your investment portfolio under the low interest rates regime.

If the general interest rates rise, say to 8 percent, the value of the bond already issued with an interest rate of 5 percent in the open market will go down. No one would want to buy a bond on the secondary market with an interest rate of 5 percent when new bond issues are paying 8 percent.

On the other hand, if the interest rates go down to 3 percent, the bond will increase in value. Any investor will grab the bond with a yield of 5 percent you are issuing on the secondary market because new issues are only yielding 3 percent. The bond issuer will take advantage of this by selling the bond at a premium on the secondary market.

Changes in interest rates also affect equity investors indirectly. This is because, for example, when interest rates rise, borrowing costs for companies also increase. This could lead to the company borrowing less, which may result in less spending. A decrease in spending can lead to a decline in corporate growth and lead to lower profit and stock prices.

Market risk

In essence, a market is a medium that permits buyers and sellers of goods and services to interact in order to facilitate an exchange. Markets establish the price for goods and services, where sellers determine by creating supply and buyers determine by creating demand.

Driven by supply and demand, prices must fluctuate and that creates volatility.

You will notice that the prices of some goods move more than others. The same is true in investment markets. Different investments have different levels of volatility. Investments expected to generate higher long-term returns (such as shares) generally show greater volatility in the short term.

You have to accept that the volatility is an inherent characteristic of higher returning assets. Volatility becomes a problem only if you don't have the time to ride it out. It's important to remember that markets move up and down in the short term. You may be tempted to sell an investment if its value falls. However, history proves that having the discipline to stick with quality assets is generally a more successful strategy over time.