Investment concepts and your risk profile

Factsheet

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There is no one-size-fits-all investment strategy. So, it's important to understand your own investment risk profile. This factsheet explains some of the different types of underlying risks you might face as an investor, factors that should be taken into consideration when determining your risk profile, and the importance of diversification when investing.

What is an individual's risk profile?

Essentially, your risk profile is your willingness to accept the risk of capital loss or negative investment returns over the short to medium term, in exchange for the potential of higher returns over the longer term.

A comparative example of an individual's risk profile would be the perception of investment in direct property as opposed to direct shares. Investment in property is usually a long-term investment and as it is generally viewed this way, the day-to-day movement in property prices is not usually a consideration or concern for the investor. Direct shares listed on the Australian Stock Exchange (ASX), on the other hand, while also long-term, can be traded on a minute-by-minute basis. This means that the volatility in prices is more obvious and causes shares to be viewed as higher risk.

Investment-related concepts

Before we explore risk factors that impact your risk profile, other investment-related concepts that are worth explaining are set out below.

- **Investment risk:** This is the difference between the expected return and the return actually realised from investments over time.
- **Risk/return trade-off:** the risk/return trade-off is a concept that states with higher investment risk, you may have the possibility of higher returns. However, it is noted with higher investment risk there is no guarantee of this outcome and it may also result in higher potential losses.
- **Volatility:** this is the movement of asset values over time, both up and down. For instance, if investment values change dramatically over the short term, those investments could be considered to have high volatility and therefore be riskier when compared against say a cash investment whose capital will remain constant with variability only in the interest it might earn.

Some investment types have greater volatility than others, so it's important that you're comfortable with the volatility of the investments you have, or could have, in the future.

Risk profile considerations: investment asset classes

There are four main investment asset classes you can invest in: shares, property, cash and fixed interest.

Shares and property assets are known as growth assets. This is because they usually have the potential for both capital appreciation and income generation, while also demonstrating higher levels of risk.

Cash and fixed interest are known as defensive assets. They can generate some income, but often don't have the potential for capital gains and are generally less risky than growth assets over the longer term as the capital value can be more certain.

Defensive assets usually have a lower risk and lower return profile relative to growth assets.

There is another asset class which is often referred to as alternatives. These can include many different areas such as infrastructure, private equity, venture capital, commodities and agriculture. Assets in this category may be either growth or defensive.

The chart below demonstrates the potential risk/return trade-off for the four main asset classes.

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Risk profile considerations: volatility between the different asset classes

To help you understand the volatility in the investment asset classes, you can review historical investment performance and volatility, although it is important to know that past performance is no guarantee of future performance.

When making investment decisions, it's important to invest in line with your risk profile, i.e. how willing are you to see fluctuations in the value of your investment on a regular basis?

Reviewing the historical investment performance and variation of returns may help you understand which asset classes might meet your risk-return appetite, as set out in Table 1 and Table 2 below.

Table 1 shows the long-term investment performance of some of the more notable asset classes in Australia over 20 years up to 31 December 2019.

Asset class	Average (geometric)	Minimum	Maximum
Australian equity	9.7%	-37.53%	39.12%
International equity	4.1%	-27.44%	48.03%
Australian listed property	6.6%	-53.85%	34.22%
International listed property	8.5%	-33.68%	36.59%
Global infrastructure*	1.1%	-28.06%	24.19%
Australian fixed interest	6.1%	1.73%	14.95%
International fixed interest	7.1%	1.65%	11.57%
Cash	4.2%	1.5%	7.6%
Inflation	2.6%	1.5%	5.8%

Source: Bloomberg
*Index inception 2007

Table 2 shows the variation in returns for those same major asset classes in Table 1 every year for the past 10 years. Notice that no one asset class is consistently the best performer. Defensive assets have historically provided lower consistent returns over time, while growth assets have provided higher returns along with significant volatility.

Asset class	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Australian equity	39.1%	2.9%	-9.2%	22.2%	22.0%	7.1%	4.2%	13.4%	13.4%	-1.5%	25.0%
International equity	-0.3%	-2.0%	-5.3%	14.1%	48.0%	15.0%	11.8%	7.9%	13.4%	1.5%	28.0%
Australian listed property	7.9%	-0.4%	-1.4%	33.0%	7.2%	26.7%	14.4%	13.2%	5.9%	2.9%	19.5%
International listed property	4.0%	8.6%	-3.3%	23.8%	19.0%	29.9%	13.3%	4.2%	-0.5%	3.9%	21.3%
Global infrastructure	22.9%	11.2%	12.0%	14.4%	20.6%	24.0%	-1.3%	12.7%	14.8%	-1.9%	24.2%
Australian fixed interest	1.7%	6.0%	11.4%	7.7%	2.0%	9.8%	2.6%	2.9%	3.7%	4.5%	7.3%
International fixed interest	8.0%	9.3%	10.5%	9.7%	2.3%	10.4%	3.3%	5.2%	3.7%	1.6%	7.2%
Cash	3.5%	4.7%	5.0%	4.0%	2.9%	2.7%	2.3%	2.1%	1.7%	1.9%	1.5%
Inflation	2.1%	2.8%	3.0%	2.2%	2.7%	1.7%	1.7%	1.5%	1.9%	1.8%	1.8%

Source: Bloomberg

Risk profile considerations: other types of risks associated with investing

There are various risks associated with investments. These risks are summarised below, affecting an individual's risk profile and to be considered before investing:

Risk	Description
Investment-specific risk	The possibility that a particular investment may underperform the market or its competitors.
Market timing risk	The possibility that your investment may be sold at a time when the sale price is at a low point or purchased when the sale price is at a high point. This also takes into account trying to pick the bottom and top of the market when investing.
Inflation risk	The possibility that your investment return is below the inflation rate, which reduces the spending power of your money over time.
Credit risk	The potential failure of a debtor to make payments on amounts they have borrowed.
Interest rate risk	The possibility that your investment will be adversely impacted by a fall or rise in interest rates.
Legislative risk	The possibility that a change in legislation will impact the appropriateness of certain investments for you.
Liquidity risk	Relates to the ease with which you can sell or liquidate your investments. Some investments impose exit fees or have limitations on withdrawals. Other investments may be difficult to sell due to a lack of buyers or they may incur large costs to buy and sell such as direct property.
Currency risk	Relates to global investments. It is a form of risk that arises from the change in price of one currency against another. Whenever investors or companies have assets or business operations across national borders, they face currency risk if their positions are not appropriately hedged.
Hedging risk	Relates to a technique designed to reduce the risk from part of an investment portfolio, often by using derivatives. While hedging can reduce losses, it also has a cost and therefore can reduce profits.
Opportunity cost	Relates to the investment return you may forego from an asset as a result of investing in your preferred asset. That is, there is a risk that the preferred asset you invest in may not return more than the next best alternative asset you did not invest in.

Risk profile considerations: diversification

By spreading your money across multiple asset classes, you can diversify your investment portfolio risk. Doing this helps reduce short-term volatility, as each asset class generally performs differently in different circumstances, especially if financial markets experience an adverse economic event.

However, a diversified portfolio does not guarantee gains or protect against losses. Diversification is about selecting a mix of investments to help you achieve more consistent returns, while being comfortable with your risk and return attributes over time. The age-old saying of not putting all your eggs in one basket is the simplest way of considering diversification and its benefits.

Table 3 below provides you with an indicative asset allocation, expected returns and the probability of negative returns for different types of investor portfolios. The asset allocations here are typical of the way Doctors Wealth Management approaches the diversification of client portfolios.

Investor type	Secure	Conservative	Moderate	Balanced	Growth	Aggressive	All equity
Australian shares	0%	5%	10%	17%	23%	30%	32%
International shares	0%	7%	14%	24%	35%	45%	53%
International property	0%	3%	3%	5%	7%	8%	8%
Global infrastructure	0%	0%	3%	5%	6%	7%	8%
Total growth	0%	15%	30%	50%	70%	90%	100%
Australian fixed interest	0%	28%	23%	18%	11%	4%	0%
International fixed interest	0%	21%	17%	12%	7%	3%	0%
Cash	100%	36%	30%	20%	12%	3%	0%
Total defensive	100%	85%	70%	50%	30%	10%	0%
Minimum investment timeframe	0 years	2 years	3 years	5 years	7 years	9 years	10 years
Number of negative years in 20 years	0 years	1.9 years	2.7 years	3.8 years	4.5 years	5.1 years	5.8 years
Expected probability of a negative return over any single year	0%	10%	13%	19%	23%	25%	29%
Expected long-term return	3.50%	4.20%	4.70%	5.50%	6.20%	6.90%	7.40%

Source: Morningstar

Risk profile considerations: longevity

A lot of emphasis is placed on the risk of negative returns from investments, which can lead people to be overly cautious in their investment decisions. However, there is another aspect to consider when investing – longevity risk. This is the risk you may outlive the capital you have accumulated throughout your career to support you in retirement.

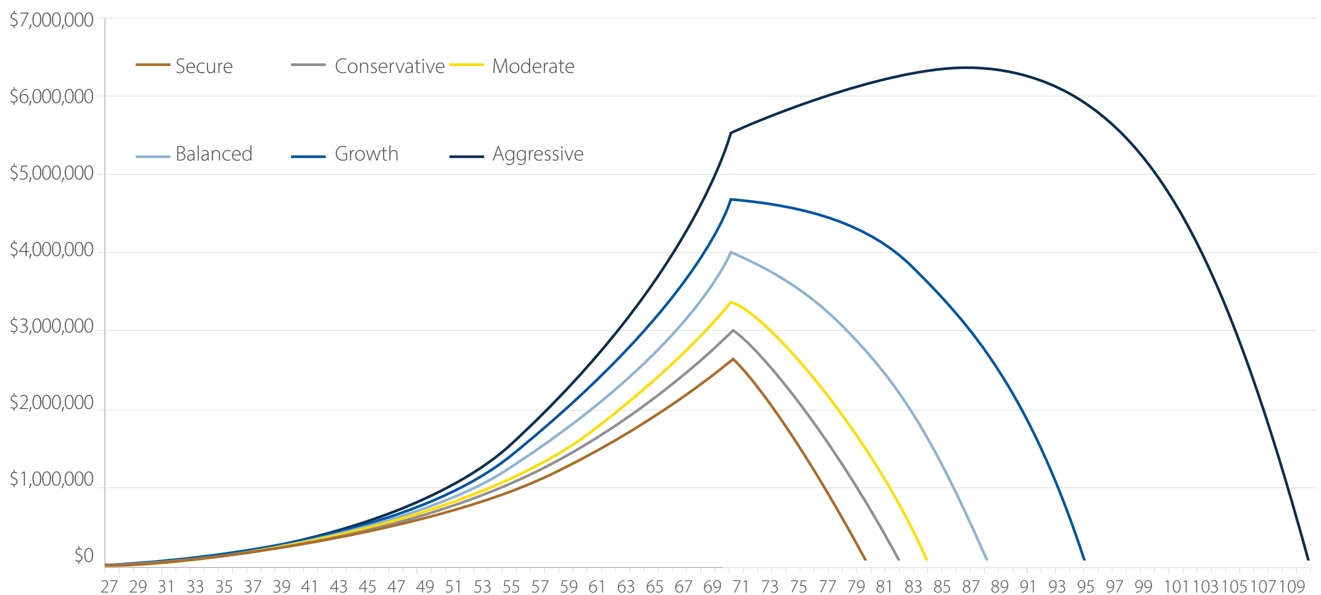
It is essential to consider what your future income needs might be in order to adopt a proper approach when setting your asset allocations to achieve this objective.

A key strategy to mitigate this risk is to ensure your investments are diversified appropriately, taking into account your risk profile and your long-term financial goals. This is not something to consider just at retirement age, but as early as possible in your career.

The opportunity cost of not investing appropriately in your investment portfolio or superannuation is exponential over time.

Example: forecasting retirement income

Dr Silver is 27 and has started her career as an intern on $70,000 p.a. Over the next 10 years, she can reasonably expect her income to increase on average by 15% p.a. Once a fellow, conservatively her income will start to plateau but still increase by 3% p.a. Assuming that the current super contribution rules of 9.5% offer her income, inflation of 2% and that she retires at age 70 with a retirement income requirement of $100,000 p.a., here are her outcomes based on different risk profiles:



Note: the forecasts above are merely examples of possible retirement savings over time. Actual returns would vary as a result of investment return fluctuation, inflation and other factors.

Here, we can see that Dr Silver would only be able to sustain a retirement income until age 81, or the first 11 years of her retirement. By taking on additional risk, she may be able to increase her retirement income by up to an additional 32 years.

Consideration

- If you have a long working life ahead of you, getting advice early can ensure that you have the best chance to meet your goals later in life. Don't rely on default investment allocations in your superannuation; these may not be right for you.
- If you are nearing retirement, think about what lump sums you may need from your investments and superannuation for expenditure such as paying off a mortgage and retirement plans such as a new car, home renovations, relocation or holidays. It may be prudent to reconsider where these amounts are invested so that you have certainty of access to them when needed. For amounts intended to generate a retirement income to mitigate longevity risk, a different approach is needed as your timeframe is still your life expectancy, which could be another 20 – 30 years.

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Risk profile considerations: COVID-19, market volatility and the share market

The current situation with the COVID-19 virus highlights perfectly how volatile the share market in particular can be on a short-term basis. We have seen the market in Australia move from 7255 points as at 20 February 2020 to 5110 points on 31 March 2020.

The chart below shows you what has happened in previous events of large share market falls and how long they have taken to get back to where they were prior to the fall. When a share market is low and falling it is known as a bear market.

Peak	Trough	Fall	Recovery (months)
Jun 1972	Jun 1975	-38.44%	49
Nov 1980	Mar 1982	-36.99%	20
Sep 1987	Feb 1988	-44.39%	71
Jan 1994	Jan 1995	-20.48%	15
Jun 2001	Sep 2001	-19.75%	33
Oct 2007	Feb 2009	-50.48%	129
Jan 2020	Mar 2020	-26.97%	Ongoing
Average		-34.89%	53

What this really tells you is that, generally speaking, investing in the share market can be an effective long-term investment strategy.

Get expert help to plan for your future

Whether you're new to investing, or looking to update your portfolio, a Doctors Wealth Management financial adviser can help. To discuss your situation and investing goals, contact the expert team at Doctors Wealth Management.

You can find additional resources and information about Doctors Wealth Management at **avant.org.au/doctorswealthmanagement** or call **1800 128 268**.

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