

How can you be sure your investment is safe?

The current turmoil in our finance company sector - and the related issues in the US sub-prime sector - have brought many investors back to this eternal question once again.

The simple answer is that, generally speaking, you can't - not absolutely. The nature of investing means there is always an element of risk involved. But not all risk is bad. In fact, some exposure to 'risky' assets is essential for most investment portfolios. In this article we look at the meaning of risk in investments, and how you can use this to help you make a sensible investment.

There are two meanings of the word 'risk' when you are talking about investing:

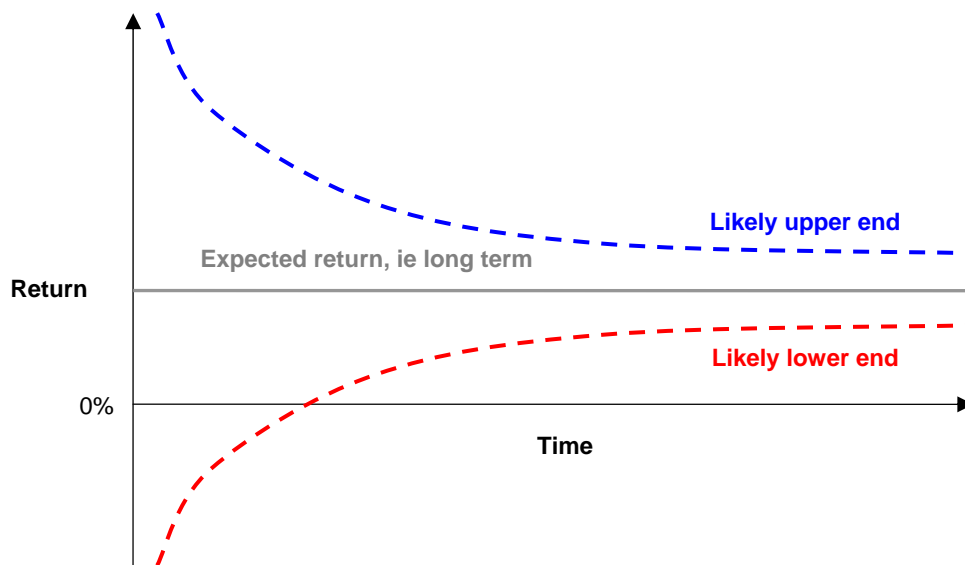
1. The chance that your actual return will be different from what you expected (in other words there is 'upside' and 'downside' risk to consider).
2. The chance that you will lose some or all of your money (the focus is only on 'downside' risk).

The two meanings apply to different kinds of investment.

Flat, up or down

With a diversified portfolio of shares 'risk' has the first meaning above. You own a small piece of a large range of carefully selected companies. Over time some of the shares in your portfolio will perform 'as expected' (say around 10% per annum), some will boom, and others will tank. But very importantly, in a share portfolio like this, **the longer you stay invested, the less risk you take**. This is because the various ups and downs tend to be averaged out over time.

This is illustrated in Graph 1 below. Most of the time, the returns from a share portfolio will be somewhere between the red and the blue lines. But this 'corridor of expectation' gets narrower and narrower as time goes on.

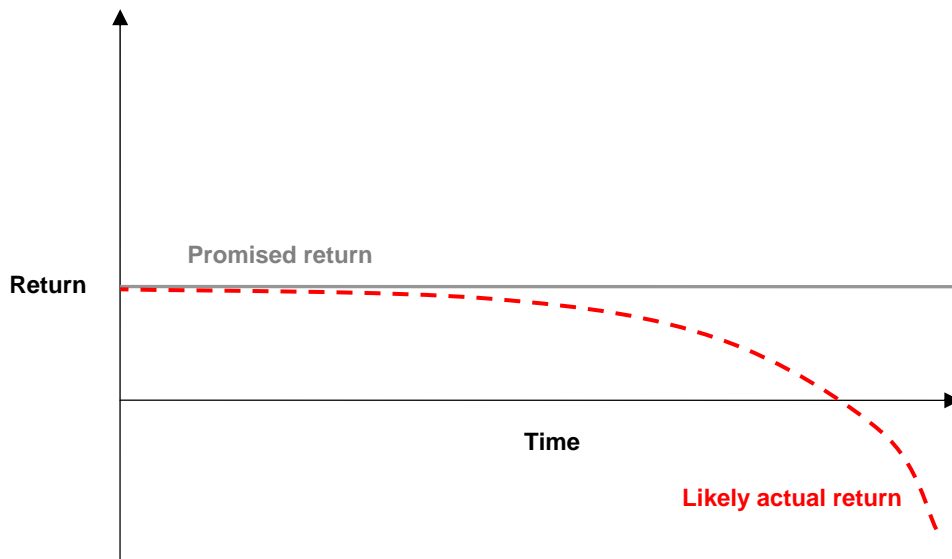


Flat or down only

An investment in a finance company debenture (or any investment where your return is interest only) is quite different. Here 'risk' has the second meaning shown above.

You give your money to someone who promises to give a certain amount of interest, and to return your capital after a certain time. And they will make these payments if they can... There is no chance you will get more than what was promised, so your investment has no 'upside'. You will either get what you were promised, or something less. And oddly enough, **the longer you stay invested, the more risk you take** (each additional year opens more opportunities that something will go wrong). It is easy to understand this using a personal example: if you loan someone \$1,000 for a few days (say until pay day) you would be taking less risk than if you loaned them money for ten years. Not much usually changes in a few days, but a lot can happen in ten years. They might lose their job, develop a gambling habit, get sick, or move house, for example - all of which could make it harder for them to pay any interest or for you to get your money back when the loan is due for repayment. The same kind of thing can happen with a finance company or other company that borrows your money.

This is illustrated in Graph 2 below. With an interest bearing investment you can only get the promised rate of interest or less. And as time goes on the risk that something will go wrong increases.



How can this information help you?

Everyone must accept that if you want higher returns you will need to expect more risk. But:

There is very little point in taking extra risks if you are investing for the short term. If you have \$10,000 to invest for three months, then a debenture offering 10% pa should give you \$167.50 in net interest (after 33% tax). A term deposit offering 8.5% pa should give you \$142.38. Is the extra \$25.13 really worth the extra risk involved? Over short periods of time, risk is your enemy.

But returns really do matter when you are investing for the long term. If you have \$100,000 to invest for 20 years, a diversified share portfolio is a much better bet than interest bearing deposits, even if they are offering the same expected return. Over long periods of time the right sort of risk (ie, the up and downside uncertainty in a properly diversified share portfolio) is your friend.

And especially with long-term investments you should consider getting professional advice. Call the Institute of Financial Advisers on 0800 404 422, or go to www.ifa.org.nz to find a professional adviser in your area. A professional financial adviser can help you select the right sort of investment risk, and use it to your advantage.

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