FIVE STEPS TO MANAGING YOUR RISK

Most investors don't understand risk. This was clearly illustrated during the financial crisis of 2008/9 when financial institutions and private investors alike were devastated by losses during the market crash. Any person attempting to beat inflation, is going to experience losses during an investment career. As any good money manager will tell you, investment risk is not a one way street. Even if you are successful as an investor, there are times when the markets will take some of your money. The real art is to ensure that these losses are manageable and that they fall within your overall investment strategy.

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Before making an investment, you should ask yourself five questions:

1. What is the term of the investment?
2. What is my growth objective?
3. What is the benchmark for the investment?
4. What is the maximum loss that I can tolerate?
5. Do I understand the investment or is it like some mysterious black box that will hopefully make me money?

Investment risk carries a specific meaning, it is the risk of your capital depreciating in value because the specific investment has dropped in value – it might recover again with the benefit of time. This is very different from other types of risk, for example when a bank collapses and you lose your bank deposit forever. If you place money in something that has investment risk, you should plan to leave the money there for a minimum period of three years. If you have an investment term of less than three years limits you should only invest in cash.

QUESTION 1: TERM OF THE INVESTMENT

This is probably the most important question to be answered. If you plan to use the money within 12 months, don't choose shares because the risk is that they will lose value in such a short period. If you don't know when you may need your capital, you should have a spread of investments. You can then access the cash investments first and give yourself time to sell the more risky investments if you need the money unexpectedly. This will be especially helpful during a market downturn.

QUESTION 2: GROWTH OBJECTIVE

Once you have established the minimum term of your investment, you need to decide what type of growth you would like. Simply put, the higher your growth objective the greater the risk of the investment. If you want maximum capital growth and your term is five years or longer, you should invest in shares. If your term is 3 to 5 years, then you should look at bonds or a combination of shares, listed property and bonds with a greater portion in bonds.

QUESTION 3: BENCHMARK OF THE INVESTMENT

A benchmark is the return objective that is set by the investment manager or product provider. For example, a share portfolio would usually have a benchmark like the All Share Index. Benchmarks can be good indicators of the risk of the investment. If you are investing in a unit trust to generate

income, you need to be wary if the benchmark is the All Share Index. For more complex investments, a benchmark can assist in your understanding of the product. A diversified investment that owns shares, bonds, property and has some derivative exposure could be a highly geared hedge fund or a low risk income fund. If the benchmark is to beat the All Share by 3% per year, you can be assured that the investment carries high investment risk.

QUESTION 4: MAXIMUM LOSS YOU CAN TOLERATE

This is a more difficult question to answer and is usually the focus of "risk profile" questionnaires that insurance companies love. If you are the type of person that will not lose sleep if your investment has lost money in the last six months, you have a tolerance for risk. If you stay awake worrying because your ETF investment is down and you could have done better with a bank deposit, then you probably have little tolerance for risk. Unfortunately, our risk tolerance changes over time. Factors such as our age, experience with investments, current economic conditions and our financial position influence our tolerance for risk. You need to try to understand the maximum loss of an investment before making your decision. For example, if you want to buy shares, understand that they can lose 50% of their value in a big crash and still recover over subsequent years. If you know that a 50% loss is likely to send you over the edge, perhaps you should limit your investment in shares.

QUESTION 5: DO YOU UNDERSTAND THE INVESTMENT?

Don't be afraid to ask "dumb questions" because these are usually the ones that will save you. Warren Buffett freely admits that he does not understand IT companies even though they are some of the greatest shares to own. As a result he simply does not invest money in them, he finds other businesses that he understands. This strategy seems to have worked well for him over the last 60 years and is worth emulating. You should always follow the "too good to be true" rule. If an investment is guaranteeing you 20% per year for the next five years - you can assume that it is a scam. Don't be fooled by the fact that a large bank is offering you the product, many large banks have been investors in scams on behalf of their clients.

Whilst it is very difficult to make good investment decisions, it is not too difficult to avoid the really poor ones. Do your homework before making a decision and ask the "dumb questions"; you will never regret knowing more about your own investments, whereas you may regret knowing too little.