Hong Kong Investment Funds Association
Frequently Asked Questions re funds' risk assessment

What is Risk?

Risk can be defined as the chance that something negative will happen. Most investments carry some risk. If someone offers us an investment opportunity, it is important to find out what risks are involved. ALWAYS question any investment promising no risk; it's almost certain to be untrue.

How is it measured?

There is risk all around us affecting everything we do and at all different levels from high to low.

So, if we don't wear sun protection on a hot sunny day at the beach the chance of us burning is quite high. If we buy a pair of shoes without trying them on there is a medium chance they may hurt our feet.

The same applies to investment risk. If we choose an investment with high risk in anticipation of earning a high return, there is a greater chance the investment will not perform as well as we expected and we could lose some or all of our money.

If we choose an investment with low risk, there is less of a chance the investment will not perform as well as we expected and we are less likely to lose some or all of our money.

Investing in high-risk products is not a bad thing, provided we understand the risks and it fits in with our investment strategy and risk appetite.

However, we must remember that ALL investments carry some level of risk and there is ALWAYS the chance that we could lose some or all of our money.

Why do I need to understand risk?

It is important investors realise markets can go up as well as down. This means as well as making money, we can lose money. We may think we are good investors and always make the right decisions, but we must be very careful because one day we may make the wrong decision.

Are there different types of risk?

Yes, there are many different types of risk and each one has its own level ranging from very high to very low. It's important for us to recognize different types of risk and how they can affect our investments. Be careful, because sometimes an investment can be affected by more than one risk.

The different types are:

Market risk:
The markets we invest in such as property, shares, funds or bonds can be affected by many different things, forcing the value of our investment up as well as down. A shortage of property can make the value of a flat rise, poor results can make the value of a company's shares fall, and even the weather can affect the values of some funds and

other investments.

Inflation risk or the Purchasing Power Risk:
Inflation risk is when the return from our investment is less than the rise in inflation. So, if inflation is running at 5 percent and the return from our investment is only 3 percent, there is a short fall of 2 percent.

Interest-rate risk:
If our investments are interest rate-linked – such as bonds, rising interest rates means the value of the investment can fall. There is an inverse relationship between bond prices and bond yield, which means as bond prices go down, the yields go up (and vice versa). The price of a bond carries an interest rate risk because if interest rates rise, outstanding bonds will not remain competitive unless their yields and prices are adjusted to reflect the rise.

Currency risk:
If our investment is in a foreign currency, we can lose money from changes in the exchange rate. So, if we are buying into an investment denominated in a foreign currency that is gaining in strength, over time we will be able to buy less and less of that investment. Also, if our investment is held in a strong currency and we want to liquidate it into a weak currency, we will lose money.

Credit risk:
If the issuer of the bond misses a promised interest payment, the value of the bond will fall as there will be concerns over whether the issuer can make future payments.

Liquidity risk:
If we cannot sell our investment at the prevailing market price for cash quickly enough, we could suffer from liquidity risk. The time it takes to sell or liquidate our investment can depend on many things such as the number of buyers and sellers at that time. It also depends on the quality of the investment. For example, it might be easier to sell shares in a global bank than shares in a local watchmaker. Also, there might be more people willing to buy a new flat than an old flat.

Political risk:
Un-popular governments, wars, and social unrest can affect the risk level of investments linked to these countries.

Policy risk:
Changes in government policies and regulations can also impact on investments. For example, a Government may decide to order power firms to cut back on the emission of pollutants, which could put downward pressure on the value of the company's shares. Or a decision to build more houses in a property-driven economy such as Hong Kong could put downward pressure on the value of an apartment.

Why do I need an objective?

It is very important to have an investment objective as it can help us assess levels of risk. For example, if we are saving for retirement in 30 years we might want to choose an investment with a medium to high risk level. If we are saving to buy a new car next year, investment should not be very high risk given the short horizon. It is a very personal choice as different people have different objectives so take time to sit down and work out what your objective is.

The key to successful investing is to choose products with a level of risk that you are comfortable with. In that way, you won't be disappointed or confused when you receive you investment return.

What does "Volatility" mean?
Volatility is the measure of how much the value of the investment moves up and down in a specified period of time.The more sensitive an investment is to changes in market conditions, the more volatile it is and therefore its level of risk is considered high. An investment that is less sensitive to changes is considered to have low volatility and is therefore considered low risk.

How is volatility measured?

It is usually measured by using the degree to which returns fluctuate around their monthly average (usually over the past 36 months).

What causes volatility?
There are many things that cause volatility from the type of market we are investing in to the excitement surrounding a particular sector. So-called "trendy" stocks like bio-companies or nano-technology companies are likely to be more volatile than blue-chip stocks because their markets are very new and they have not established a good solid reputation like banks.

Also, a portfolio of just a few stocks or funds is likely to be more volatile than one with many. And investing in just one sector can also leave you vulnerable to volatility.

How do we avoid risk?
You cannot totally avoid risk, but you can manage the level of risk you are exposed to. Make sure you understand exactly what you are investing in and recognize the potential problems. Once you have identified the risks, you can take steps to manage them.

How do we find out more about investment risk?
We should take the trouble to learn about the products we wish to invest in. Read prospectus, offer documents, annual reports and announcements carefully. Pay attention to the "risk factor" sections or "risk warning" messages. If someone tells us something is a good investment, we must check ourself. We must NEVER rely on the word of just one person.

How can we reduce our investment risk?
One of the best ways to reduce investment risk is to 'diversify' or spread our money around. In this way, even if the value of individual markets or companies moves up or down, our overall return is going to be more stable as we are less dependent on the return from any single investment. Remember: *diversification across stocks, asset classes, countries, and industries will reduce volatility of the overall portfolio*.

What are the risks involved in investing in different types of funds?
Risk and return varies from fund to fund. Here are just a few examples.

Equity funds:
Investing in an equity fund means we are basically exposed to the same risks as if we had invested in the stocks directly. These can be shocks that affect the company or the market in which it operates. A diversified equity fund can help reduce the level of risk, and

divert it away from the company to the market.

Bond funds:
Investing in a bond fund means we are basically exposed to the same risks as if we had invested in an individual bond.

The risks include:

- *Credit risk:* the issuer may fail to pay the interest on the principal as scheduled. If a bond issuer has financial problems, the credit rating of its bonds will be adjusted downward.
- *Interest rate risk:* since the interest rate is fixed at the time of purchase, if the interest rate goes up afterwards, the attractiveness of our bonds will diminish and the price will go down accordingly.
- *Liquidity risk:* we may need to cash in our fund early if we have an urgent need for cash to pay bills or for other investments. This could mean our investment has not been given enough time to realise any significant return.
- *Inflation risk:* when inflation goes up, the purchasing power of the principal we receive upon maturity will be lower.

Money market fund:
Compared with equity or bond funds, money market funds carry relatively low risk. The objective is to preserve capital in terms of the fund's denominated currency rather than keep the value of the fund constant.

However, if a money market fund fails to beat inflation in the long-run, our money will be worth less.

How can we manage these risks?
An efficient way to manage risk is to diversify our portfolio. A diversified portfolio that contains many different products with varying levels of risk, tends to be less volatile than one containing a single product. Therefore, depending on our objective, a portfolio may contain a mix of investment vehicles containing equity, bonds, and currencies across many market sectors and from many different countries.

How do we assess our risk tolerance?
Our risk tolerance relates to our ability and willingness to absorb losses. Some people are able to tolerate short-term loss if it still means they'll reach their long-term objective. Others get very nervous when their investments drop in value.

What else do I need to know?

- Investment time horizon: the more time we have to reach our objective the greater our risk tolerance.
- Cash demands: If we need ready cash we are more likely to invest in vehicles that are liquid and of lower risk.
- Resources: people with small financial resources are less able to absorb risk.
- Tolerance: If fluctuating markets keep you awake at night, then you should consider low risk investments.

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