INVESTMENT RISK AND RETURN

In general, risk can be defined as the uncertainty of future outcomes.

Investment risk, more specifically, is the probability that the actual return from an investment may differ from the expected (or desired) return. This includes both the possibility that the actual return may exceed what was expected and that it may be less. Actual risk is therefore symmetrical, but people's attitude to risk is asymmetrical: most people are more concerned with (fearful of) the possibility of loss (risk-averse) than the opportunity of gain (risk-loving).

The asset classes available in the marketplace as instruments for investment differ widely in terms of their risk vs return properties. A savings account eg would be the least risky as there is no uncertainty about the future return (interest rate) it will provide. The return on such low risk investments is therefore low. No uncertainly, low risk, low return.

Investment in equities (shares) presents a high degree of risk due to the uncertainty around the future profitability of companies and the general state (growth or recession) of the economy. The return from investing in shares is twofold: the dividends declared by companies, which is a way of distributing their profit amongst the shareholders and secondly, the appreciation of the share price on the stock exchange (the JSE in South Africa). Given this high degree of uncertainty, investors are only willing to invest in shares if a higher return (than say the savings account) is possible. Hence high risk, high return. The risk from investing in equities is measured by the past volatility (extent of up and down movement) in the share price. High volatility means more uncertainty (fear) going forward, hence high risk. Share prices, and the stock market in general, are subject to short term fluctuations (ups and downs), but shares remain a critical asset class to include in a portfolio for growth over the long term, over which it outperforms most other assets available to investors. Meeting retirement targets therefore requires exposure to equities.

Investments are normally organized in portfolios (a combination of low risk, low return assets and high risk, high return assets for the benefits of diversification, or to quote the old adage: not having all one's eggs in one basket. The potential underperformance of one asset class can therefore not pull down the whole portfolio. A typical investment portfolio would be structured to comprise around 60 percent equities, 30 percent bonds and 10 percent cash. When there are strong prospects of the economy going into a growth phase, portfolio managers would increase the equity component (say to 70 percent) to capture more of the upside growth, while lowering it when the economy is heading for a recession, to minimize the downside.

Planning for retirement requires a balanced portfolio approach, which includes equities, bonds and cash to name only the three most prominent ones. In a provident fund, the members' contributions can be invested in a variety of portfolios, structured with different compositions of the asset classes according a member's age (and therefore the time period of the investment horizon, which in this case is the date of retirement), outlook and sentiment about the economy. The selection of a portfolio can be done through member choice or default placing according to the life stage model. This means that for young members with many employment years ahead of them, a portfolio with a high equity component (higher risk, higher return) would be chosen, whereas when members come close to retirement (low risk, low return), exposure to equities is reduced in order to shield the portfolio from potential negative returns in the short term, should the market fall. The investment risk is therefore actively managed over the member's employment.