Inherent Risk of Investment

Investment and Risks

- Different investment vehicle carry different type of risks
- The degree of risk will also vary from one investment to another

Every investment inherently has its own risk. The risk of an investment is related to the characteristics of the investment itself. Some of the risks are apparent while others are not so obvious, until something happens.

Let's examine the different types of risk among various asset classes.

Table 1: Risk Comparison

	Fixed Deposits	Local Shares	Unit Trusts	Bonds	Private Equity	Structured Products	Properties	Foreign Shares	Hedge Funds
Amount	Flexible	Small	Small	Usually RM5m	More than RM1m	Affordable now	Can be large	Moderate size	Usually large
Liquidity Risk	Nil	Depend on stock & size	Normally no issue	Depend on bond and size	Not liquid, has lock-in period	Moderate	Not liquid, worse if in less known location	More liquid	Usually monthly withdrawal
Manager Risk	Nil	Nil	Yes	Nil	Yes	Yes	Nil	Nil	Yes
Timing Risk	Not critical	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Depend on type of fund
Investment Risk	Very low	High	Generally moderate	Low	High than shares	Moderate to high	Depend on property and location	High	Depend on type of fund
Currency Risk	Nil	Generally low	Nil	Nil	Nil	Nil	Nil	Yes	Depend on type of fund

Source: PCM

Fixed Deposits - Interest Rate Risk

The simplest form of investment is bank fixed deposits (FD). Most people are savvy enough to place FD for short-term such as one-month maturity in view of the present low interest rates. When interest rates are high, it will be wiser to put the FD for longer-term maturity. FD may not have liquidity risk but premature redemption of FD may subject to penalty on interest or no interest to be paid at all.

Following liberalisation of investment where Malaysians are now allowed to invest overseas, overseas products are knocking on investors' doors. One common product that banks offer is high bearing-interest currency deposit either in plain form or in structured form. The prevailing high interest rate in Australian and New Zealand deposits have lured many Malaysians in converting their ringgit deposit for these foreign deposits. Unlike ringgit deposits, foreign currency deposits carry currency risk. Unless one has the need to own some of these currencies either for education or for holiday purposes, the risk of currency loss could be higher than the interest earned.

Stock Market – Systematic Market Risk

Unlike FD, investing in the stock market requires certain knowledge especially investment in non-blue chips. Stock market or equities investment has several systematic market risks.

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Investment in stock market requires adequate knowledge and skills.

With financial globalisation, major financial crisis in other countries will also affect our market. The market is also susceptible to political risk, economic risk, liquidity risk and sentiment risk.

As stock market in Malaysia is volatile, managing market timing risk is crucial. Buying a stock at a good timing provides a good start but the ability to exit is also important. As the market never die, there is no such thing as miss-the-boat. It is a matter of which boat to hop into and when to get off the boat.

Unit Trust Investment – Degree of Risk Varies

Bad experience in stock market have led to investors putting their money in the hands of professionals which have left to the robust growth in the unit trust industry.

Unit trust investment has gained popularity as more Malaysians avoid investing directly in the stock market. Active promotions by consultants and banks have helped to spur the growth in the unit trust industry. The risk of unit trust investment depends on the structure/nature of the fund, whether it is a pure equity fund or a bond fund or mixed-assets fund (a mixture of equity and bond). For equity fund alone, the risk will vary depending on the type of investment – lower risk for blue-chips while higher risk for small cap stocks or aggressive stocks. If the unit trust fund is based on overseas investment, there is also currency risk. Another type fund which is getting popular of late is the capital guaranteed/protected fund, where a portion of the fund locked in bonds and the balanced invested in options or futures index which provide leverage to enhance return.

Like stock investment, unit trust investment involves timing risk. Since market timing is a difficult task, even for professional fund managers, it is wiser to practise dollar cost averaging to mitigate market timing risk.

Bond Market – Interest Rate Risk and Duration

Lower rating bonds will be compensated with higher yield.

Through unit trust, investors now can invest in bonds which were traditionally the domain of institutions due to the size of investment. Unlike FD, bond it has its own risk too. On top of credit risk which is related to risk of default of interest or principal payment, bond price is affected by interest rate changes and duration to maturity. While higher risk single A rating bond has higher default risk than lower risk AA or AAA bonds, the return or yield-to-maturity as it is commonly used in bond market, is correspondingly higher.

A bond with longer maturity period or duration normally offers higher return. The risk of investing in higher duration bond is the higher price fluctuation whenever interest rate changes. The rule of thumb is that when interest rate falls by 1%, the price of a long duration bond increases by the number of years of duration. For example, a 5-year duration bond will probably gain 5% when interest rate falls by 1% and vice versa. As such, longer duration bond has higher risk than shorter duration bond.

Private Equity - Like an Option

Private equity is a high risk and high return game.

Private equity fund which is targeted at high net-worth individuals has long lock-in period may be 5 years or even longer. Investment in private equity is like buying an option where you cross your fingers and hope for the best after a few years. The expected return is normally much higher than conventional investment classes. The performance will depend on the ability of the fund manager in managing the fund.

Offshore investment is susceptible to currency risk. Fierce gyration in currency may wipe off the entirely profits made from the investment.

Foreign Share - Currency Risk

Foreign shares may be attractive to certain investors. Outside Malaysia there are many choices of first class companies. Overseas investment is unlike domestic investment. The fluctuation of currency may affect the net return when converted to ringgit. Overseas investment has two components of return – the first being the performance of foreign asset itself and the second being the performance of currency. If our currency strengthens, then the ultimate return of the foreign investment will be lower. Hence, it is always better to invest in a country where the currency is firm eg Singapore dollar and China renminbi.

It has been a myth for long that all hedge funds are speculative in nature and high risk.

Hedge Funds— A New Asset Class

Hedge fund or alternative investment is gaining popularity worldwide. Hedge funds are generally perceived as high-risk investment due to the leverage effect and lack of transparency in their disclosures. The strategies and products used in their investment are also much more sophisticated than traditional class of investment. The risk of investing in a hedge fund depends very much on how it invests and what investment approach is employed.

Hedge funds have proven to be able to generate more superior returns than most traditional assets classes and maintaining lower volatility.

There are many hedge funds with very low volatility of return due to their wide diversification as well as risk management control. Examples are funds which invest in many other specific hedge funds to achieve wide diversification (commonly known as funds of hedge funds), long-short funds which invest in one asset but hedge by shorting (which means selling) another asset to reduce market risk, and multi-strategy managers which try to generate alpha (or excess return excluding market risk) in various facets of investment domain.

In fact, not known to many, numerous hedge funds depict low standard deviation of return. In terms of risk adjusted return, they beat most of traditional classes of investment over time. Their ability to hedge and to protect investment in a down market is the main advantage of hedge funds.

Diversify your portfolio in managing your overall risk exposure.

Manage The Risk

As every investment has its own inherent risk, managing this risk is crucial. Diversification is one way to mitigate risk – diversification in terms of asset classes preferably in those which have low correlation; diversification in terms of timing of investment; diversification in terms of geographic location; and diversification through different fund managers or investment styles are something to consider. Such wide diversification is difficult to achieve with limited capital but adequate diversification is definitely something to ponder in investment.

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