talk money with Ecstra Foundation

Finance facts:

Financial risk

What is a financial risk?

Financial risk refers to the possibility of losing money or failing to achieve expected returns on investments and financial decisions. There are many ways people can lose money they have invested, whether it is a small amount used to start their own business or a large amount invested in their family home.

The time value of money

The key issue is time. Over time, any number of changes can happen, some of which are in your control and others which are not. The longer the timeframe, the more likely things will change, which will affect the value of your investment.

Time is a key factor that matters to investors. To make it worthwhile, investors give up the opportunity to spend their money now and instead invest it, expecting to get their initial investment back plus a profit (or return) on that investment. Investors also think a lot about inflation. Inflation is when prices rise over time, and you can buy fewer goods with the same amount of money. Investors want to earn a return on their investment above the inflation rate. This means they maintain their purchasing power.

The role of probability in assessing financial risks

Some events are more likely to occur than others. To understand the likelihood of events occurring, we often look to past information to give us an idea. But things could happen in the future that we didn't predict.

The COVID-19 pandemic is a great example of an event that wasn't predicted to happen, and it negatively affected a great many individuals and businesses across the world. This is a type of risk that is difficult to predict and out of our control. Another example of an unpredictable risk is war. Climate change is also causing more extreme weather events than historical patterns tell us are likely to occur. This will affect the values of homes in areas prone to fires, floods or cyclones.

The same unpredictability could occur in stock markets. The stock price of companies you invest in might have higher highs, or lower lows than the historical price trends tell us should happen. This is known as volatility, and it makes investing in these companies riskier. If the stock price is more stable over time, then it is safer.

Some types of investments are more at risk of being negatively affected than others. When we compare investing in the stock market to putting our money in an interest-bearing account at the bank, there is less probability that anything will negatively affect the money in the bank, and we will be nearly 100% sure we will get that money back plus interest. However, the stock market is affected by many factors, including what is happening in both the Australian and worldwide economies, as well as things that impact each company separately. It is more likely that our investment in the stock market will go up and down over time.

Understanding the role of the probability of events occurring, in conjunction with the fact that more things are likely to change the longer the money is invested, helps to better assess financial risk.

Ability versus willingness to take risk

People differ in their level of comfort with risk-taking. Some people like taking risks in their lives—you might see this in physical activities like motorbike riding or surfing. In the financial realm, entrepreneurs are often risk-takers—they start new businesses not knowing what the outcome will be. Other people need a steady income or certainty with their money to feel secure.

Your personal *willingness* to take financial risks is different to your *ability* to take financial risks. Your *ability* to take financial risks depends on how much money you already have. If you have a financial safety net, your ability to risk a small proportion of your total wealth on an investment is greater than if you don't. Without a financial safety net, losing even a small amount on an investment could put you at risk of losing everything. Building a financial safety net is an important step to undertake before putting your money in risky investments.

Types of financial risks

The types of financial risk to consider depend what the money is to be spent on. Below are some general types of financial risk to consider:

1. **Fluctuations in prices (market risk):** Many economic—or market—factors can affect prices, including interest rates, inflation, exchange rates, and overall economic conditions
2. **Unpaid loans (credit risk):** The chance of loans associated with an investment not being fully repaid

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3. **Ability to sell the asset (liquidity risk):** If an investor needs cash quickly, they may choose to sell an asset. Some assets can take a long time to sell, which makes this difficult. Investors need to decide whether to reduce the price of an asset so it can be sold quickly (known as a 'fire sale') or hold on to the asset for longer and hope for a good price. Liquidity risk refers to the difficulty in selling an asset in a timely manner
4. **Difficulties within a company (operational risk):** Sometimes, the value of an investment can be affected by operational risks in a company. These risks can include human errors in managing a company, security breaches, fraud, or IT failures
5. **Change to laws (legal and regulatory risk)**: Some investments might be affected by changes to laws or government policy that either make it less or more favourable to invest in them.

Managing financial risk

There are several ways to manage risk. Not all risks can be eliminated. Often, investing involves conducting a risk assessment through research and a strategy for managing risk before investing. Some ways that investors manage financial risk include:

1. **Diversification:** If you have heard the term 'don't place all your eggs in one basket,' you have heard of diversification. Diversification involves spreading investments across assets with different characteristics to reduce overall risk. While some asset prices might go down, others might go up, and the highs and lows help to cancel each other out
2. **Insurance:** Insurance is a risk transfer mechanism that provides financial protection against specific risks in exchange for the payment of a premium. For example, purchasing health insurance helps individuals mitigate the financial risk of unexpected medical expenses, such as hospitalisation or surgery. People can take out insurance policies on their homes, cars, income, and businesses.

Case study: Risk tolerance

Imagine two friends, Alex and Taylor, decide to invest some money in the stock market. Alex has a high-risk tolerance, meaning that she is okay with taking on more risk for the chance of higher returns. She invests a significant portion of their savings in high-risk stocks, like small, new companies with potential for big growth. Alex knows that there's a chance they could lose a lot of money if these stocks don't perform well, but she is willing to take that risk for the potential of making big profits.

On the other hand, Taylor has a low-risk tolerance. He prefers safer investments with lower potential returns but also lower risk. Taylor decides to invest his money in more stable, established companies with a track record of steady growth, even though the potential for big gains might not be as high as with riskier investments.

Alex's high-risk tolerance leads her to make riskier investment choices in pursuit of higher potential returns, while Taylor's low-risk tolerance leads him to prioritise safety and stability, even if it means potentially lower returns.

Each person's risk tolerance influences their investment decisions and ultimately affects their investment outcomes.

Glossary

Asset	is a useful or valuable thing or person. In financial contexts, an asset is something that an individual or corporation owns with the expectation that it will provide a future benefit.
Inflation	is the rate of increase in prices over a given period of time.

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