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Lesson type: Think like an investor

How do you reduce risk?



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One of the main goals when considering an investment is to get a decent return without taking too much risk. If you can achieve this over a sustained period of time, then generally speaking you'll put yourself in a good financial position.

So, how do you do this, particularly if you use the current investment environment as a starting position? You need to consider that:

- **Interest rates are low** – meaning you get little to no return on bank deposits, term deposits, etc. If you consider inflation, which is above the rate of interest in most cases, then you're actually losing money by keeping money in the bank. This may be safe, but it's not a good long-term investment strategy
- **Property** – be it residential or commercial, has had a good run over the last decade or so, thanks largely to low interest rates. Valuations are generally considered high by historical standards. There's even talk of 'bubbles'. For some, the optimistic scenario is that property values don't fall, they just plateau for the next 5-10 years
- **Shares** – again, there has been a terrific run in mainstream equity markets like the US and Australia. We're now 10 years into a bull market, which is great except when you stop to think that a typical cycle lasts only seven. Again, the optimists point to the need for well above average growth in company profits to help support the market, but even then, it will be hard pressed to increase in value

The long and the short of it is the approach of buying and holding traditional asset classes will find it difficult to achieve satisfactory long-term returns. Certainly, not what they may have come to expect from the past decade or so.

Then there is risk – an often-overlooked element of investing. Would you risk 30 per cent of your money to make 7 per cent? Not likely, but that is what some well diversified portfolios (read: 'balanced funds') did during the GFC.

Likewise, today, the amount of potential upside is limited, but the downside is far more significant. We all know there are numerous financial, geo-political, demographic and ideological risks in the market. We've simply 'tuned out' when it comes to investing, or to put another way, we're ignoring the risk.

So, what can you do?

It all depends on how you approach investing. Do you simply buy and hold then hope for the best? Do you look for value? Growth? Dividends?

One approach that is increasingly relevant today is goals based investing. It's been around for a long time in the institutional world, but is increasingly being made accessible to other investors. Examples of goals based investors include managers like The Future Fund and The Harvard University Endowment Fund.

The Association of Goals Based Advice (<http://goalsbased.com.au/>) (AGBA) says: *"goals based advice quite simply links a client's individual goals directly to the design of their portfolios, so the likelihood of achieving those goals is improved."* That clearly makes sense, but how do you do it?

In reality, there are many ways to be a goals based investor, but there are a few fundamental beliefs that seem to be common:

- Have the ability to invest into a wide range of asset types – not just the traditional ones
- Be prepared to be dynamic in moving your capital between asset classes – don't just set and forget
- Ignore benchmarks often bandied around in the media or at BBQs (such as the ASX200, bank stocks, etc.) – these are not relevant to your goals
- Be medium- to long-term focused – trying to time the market is a mug's game over the longer-term

By taking a goals based investing approach, not only do you align your investments with your goals, you also tend to remove a lot of behavioural finance risks of buying when markets are hot (high) and selling into panic (low). It can also help with other technical risks such as sequencing risk (protecting your capital from permanent loss when using it in a drawdown phase, such as a superannuation pension).

While we might all like to invest like the Future Fund, the reality is that they have access to different types of investments, but there are a growing range of financial advisers and fund managers helping people with building and managing goals based portfolios.

There is light at the end of the tunnel.

Having worked as a specialist financial planner since 1991, Matthew has extensive experience in providing advice to successful individuals such as senior corporate executives, professionals and self-employed business executives. His plain-English approach to complicated financial and regulatory subjects has won him a loyal client following.

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