



**BALANCED INVESTMENT STRATEGIES**

FINANCE ♦ BALANCE ♦ LIFE

## **Investor Education Series**

### **The Risks Worth Taking**

**Balanced Investment Strategies**

ABN: 33 070 860 776

AFSL: 314 365

Postal Address: PO Box 1251, Palm Beach QLD 4221

Phone: (07) 5598 3800

Fax: (07) 5598 3711

Email: [info@cosgroveco.com.au](mailto:info@cosgroveco.com.au)

## Risk and Return are Related

In life, gains are rarely accomplished without taking a chance. So it is in the world of investment, where risk is related to return.

It's a trade-off. Just as taking on more risk in investment can open you up to loss, it also holds the prospect of a higher reward. Likewise, while playing it safe can limit your losses, it also means you may have to live with a lower reward.

Just how much risk you adopt is a personal decision. It will depend on your tolerance for losses, your age, personal situation and lifetime goals.

**And once you understand your appetite for risk, you need to ensure those risks you take are compensated ones.**

Many people mistake investment for gambling and end up taking avoidable risks. The irony is that speculation is unnecessary. Over many years, economists have built a strong understanding of which risks are worth taking and which are not. Their findings are based on science, not guesswork.

## Investment Verses Speculation

Much of what is described in the media as investment really is just speculation.

Speculators usually have a short-term horizon. While they like to think that their success is due to their own skill, it really comes down to luck.

They may take a punt on a single stock, sector or country. They may try to time a move out of one market into another. If it pays off, great. More often than not though, it doesn't – although you tend only to hear the success stories.

This isn't to say that speculation can't be fun. Lots of people have firm opinions about what will be the next 'hot' stock or sector. And it's good for their egos when their forecasts prove to be right.

But markets often don't behave in line with their expectations, however well thought out. If that happens and they lose their own money it is one thing. If they are speculating with somebody else's money based on a bad forecast, it is something else.

**The good news is that building long-term wealth doesn't have to depend on individual guesswork and which way the dice roll. It is about building a diversified portfolio based on risks that carry a reliable reward.**

## The Risks Worth Taking

These are compensated risks. And economists have identified three of them.

First, there is the market itself. Shares tend to be riskier than bonds. So they offer higher expected returns as a reward.

Second, small companies have higher expected returns than large companies. This makes sense, as smaller companies are more of an unknown quantity.

Third, lower priced or 'value' stocks offer higher expected returns than higher priced 'growth' stocks. A value stock is one that is out of favour for one reason or another.

These compensated risk factors are evident in every major market around the world. Think of them as the building blocks of your portfolio.

So you raise your expected return by increasing the proportion of stocks relative to bonds; of small stocks relative to large stocks and value stocks relative to growth stocks.

## The Dimensions of Stock Returns

### Three dimensions around the world

#### Equity Market

(complete value-weighted universe of stocks)

Stocks have higher expected returns than fixed income.

#### Company Size

(measured by market capitalisation)

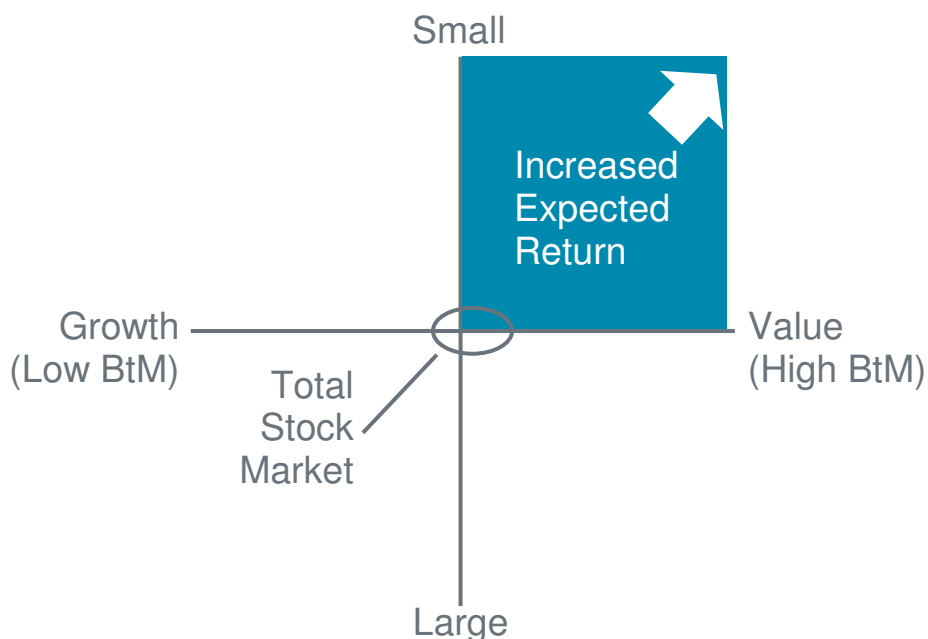
Small company stocks have higher expected returns and risk than large company stocks.

#### Company Price

(measured by ratio of company book value to market equity)

Lower-priced "value" stocks have higher expected returns and risk than higher-priced "growth" stocks.

**Expected return is determined by these three factors, not by stock picking, market timing, or random factors in returns.**



Eugene F. Fama and Kenneth R. French, "The Cross-Section of Expected Stock Returns," *Journal of Finance* 47, no. 2 (June 1992): 427-65.

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