Financial Planning

Managing Investment Risk

Working out your risk profile is the first step towards developing a diversified investment portfolio.

Franking credits, exchange traded funds, insurance bonds, listed investment companies, real estate investment trusts, mortgage-backed bonds the world of investing can be confusing for first-time investors.

So before you plunge in and start building your investment portfolio, it's important to have a plan. You'll need to work out what you're trying to achieve, how long you have to invest and what's your attitude towards risk.

Dave, Dave or Dave? How your risk profile changes as you get older

One of the biggest factors in developing your individual risk profile is what stage of life you're at. Take Dave, a pretty average Aussie bloke from the suburbs of Brisbane. Let's look at three pivotal milestones in Dave's not-so-average life.

Freewheeling Dave. Dave's hitting 30 today. As he cracks open the first Corona of what promises to be a big evening, he reflects on his first few years in the workforce. The job's going well. His social life is buzzing. And a couple of years back he met a great girl called Kate through work…he's pretty sure she's the one! But it still feels a bit early to think about settling down. He's still enjoying going out, meeting new friends and having new experiences. It's still early days for his investment portfolio but he's dipped his toe in a few exotic investments like cryptocurrencies, gold and the odd overseas share or two. Some investments have worked out better than others, others have tanked… but that's a risk he was prepared to take. After all, he's still young and he's got his whole working life ahead of him. At this stage, Dave is quite definitely a growth investor.

Family Dave. On the eve of his 40th birthday Dave reflects that the past 10 years have brought some pretty big changes. After finally tying the knot, he and Kate settled down, bought a house and started a family. Lucy and then Lachlan arrived. Pretty soon after the wedding Dave traded in his zippy Saab for a more sedate hatchback. Dave is still a fair way from retirement and knows that he needs to build his family's wealth as well as protect them from the unexpected. They need to start saving for high school expenses. But then there's the mortgage to cover, the bills to pay and the food to put on the table. It's all a bit of a trade-off. He needs diversification and he needs discipline. The days of speculating in crypto ventures are long gone. As he and Kate pore over the family investment portfolio when the kids are in bed, Dave reflects wryly to himself that he's become a balanced investor.

Future Dave. Now Dave's 50. He can hardly believe it. The kids are in high school and retirement suddenly doesn't feel too far away. Dave's conscious that he can't afford any slip-ups at this stage. While his money does need to last the distance to fund what will hopefully be a pretty comfortable retirement, Dave doesn't want to be working full time forever and so he's wary of taking too many risks, particularly if a GFC mark two ever happens. He's still invested across a mix of different assets but he's got a bit less in shares and property these days and a bit more in cash and bonds. Over a glass of cab sav that night with Kate, Dave has a wry chuckle to himself about how things have changed over the past 20 years. Dave's risk profile has changed again. Without quite knowing how, he's gradually become a conservative investor.

How do you work out your risk profile?

We're not all Dave. You might start out a bit more risk averse and end up a bit more risk tolerant.

Everyone has their own journey to make. But if you don't know what you're trying to achieve, you're unlikely to get the most out of your investment portfolio. It's not about the money, it's about where the money can take you.

And it's not just getting older that can change your attitude towards risk. You may need to adjust your investment portfolio when big life changes happen like marriage or kids—or on the flip side redundancy or illness—that affect your ability to continue earning the same income.

But it's fair to say that for most of us our attitude towards risk changes over the years as we take on more responsibilities and approach retirement.

How risk are different investment options?

Growth assets like shares and property offer great potential returns but with greater risk. You can make more money but you run the risk of losing your money.

Defensive assets like cash and bonds offer lower potential returns but with less risk. You can't make as much but you won't risk losing as much.

How can you invest inside and outside super?

Investing inside super can offer tax advantages, depending on the marginal tax rate you usually pay. Many super funds offer lifecycle strategies that automatically dial down the risk as you get older.

But you won't have access to your money until your super preservation age, which for many Australians will be after they turn 60.

Investing outside super may not bring the same tax benefits. But you may have more control over your investment portfolio.

Whether you're investing inside or outside super, it's important to make sure your investment portfolio matches your risk profile.

Then it could be a good idea to speak to a financial adviser for a more detailed assessment of your risk profile.

So whether you're freewheeling Dave, family Dave or future Dave, you'll know where you're at and where you want to get to.

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