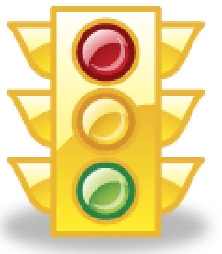
Why is the risk profile of a portfolio important?



The portfolios on offer to members of retirement funds are usually designed to be either: High Risk, Medium Risk or Low Risk (for more information on the specific portfolios available to you, please refer to the investment section on this website).

Members usually also then given the option to decide in which of these portfolios they want to be invested and then to switch their money between these portfolios from time to time.

Why are there high, medium or low risk portfolios? Should we not just all be invested in a low risk portfolio?

No! If you are invested in the wrong risk profiled portfolio, your retirement savings may be adversely affected. Let's take a look at why this is:

High risk portfolios are for long term investors, for the younger generation and members up to the age of 45 to 55. These portfolios are volatile and do tend to fluctuate considerably over the short term (over a few months or years). If money remains in these portfolios over the long term, however, **the potential for good returns are better than for lower risk portfolios**. But because they fluctuate, people panic and make incorrect choices to move their money from these portfolios to other safer portfolios when markets drop.

Medium risk portfolios are targeted at members between 8 to 5 years to retirement. Medium risk portfolios are aimed at keeping your capital safer from fluctuating markets, which means you have a smaller chance of losing your money, **but your earning potential is also smaller.**

Low risk portfolios have an even smaller potential of good returns, but with less chance of losing your money. Some of these portfolios even guarantee your capital. These portfolios are for members who will be resigning or retiring within the next year or two.

So why should we not just all be invested in a low risk portfolio? Our capital will always be safer, isn't that what we want?

No, because of the effect of inflation.

Inflation is a threat that you mostly think and hear about when you do your shopping. In food prices, petrol stations and now even clothing prices, you see and feel that your Rands do not stretch as far as they used to, even a year or two ago. This is a result of inflation, or a rise in the prices of goods and services. Therefore, the higher the inflation rate, the less your ability to buy things with the same amount of money. This applies to your retirement savings too.

Let's look at an example: In the year 2 000, you have saved R100. You could afford to buy one shirt with that R100.

If your money grew by exactly the same rate as the rate of inflation (let's assume inflation was 5% per annum) over the following 10 years, you would still only be able to afford that same shirt with your savings.

Your savings would be R164.70 (due to the 5% p.a. interest you would have earned), but the shirt would also cost R164.70, due to the rise in prices over the last 10 years (called inflation).

So even though you have received 5% interest per annum, you did not become any richer.

So do you see, if you do not earn returns equal to or more than the inflation rate, your money will actually decrease in value. **You are getting poorer!** The lower risk portfolios do not always beat inflation over the long term and that is why we want to invest in higher risk profiled portfolios, if we many years until retirement.

So what has all this got to do with my emotions?

For most of us, as soon as we smell trouble in the market, we make the decision to act without considering the long term consequences. By moving our investment from a high risk portfolio to a low risk portfolio (e.g. Money market) at a young age, we will lose the potential for high growth and our investment might not beat inflation.