Investing in Context

Risk, reward and the efficient frontier

Is your portfolio risker than you?

Every investor faces the same question: How much risk is right for me? Take on more risk and your potential returns can grow, but so can your potential losses. The key is to find the mix of investments that gives you the best chance of meeting your goals while minimising risk.

What is the efficient frontier?

The efficient frontier is a way of showing the sweet spot between risk and reward. Imagine a curve that plots the highest possible return you could get for each level of risk. Portfolios on this curve are working efficiently. They are delivering the most value for the amount of volatility or risk you are taking on.

Your aim is to move your investments as close to that curve as possible.

Before you can build a portfolio that sits on the curve, you need to know two things:

1. Your **risk tolerance** - How comfortable you are with market ups and downs?
2. Your **investment goals** - Whether you are aiming for growth, income, or a mixture of both

Know your risk tolerance

Risk tolerance is about how much risk you are willing and able to take. Generally, the bigger the potential reward, the higher the potential risk. Some people are comfortable with bigger swings in value, while others prefer a smoother ride.

Your risk tolerance will depend on factors like;

- Your **time horizon** - How long before you need access to your money
- Your **financial situation** - Other assets you hold and your ability to handle fall in value. This is also known as your '**capacity for loss**'
- Your **emotional comfort** - How you react to seeing your investments rise and fall in value

A simple question to ask yourself is "**How would you feel if my investment fell in value?**"

- If the answer is "anxious" or "worried", you may prefer a lower risk mix
- If the answer is "I would hold on and wait for it to recover", you might be more comfortable with higher risk

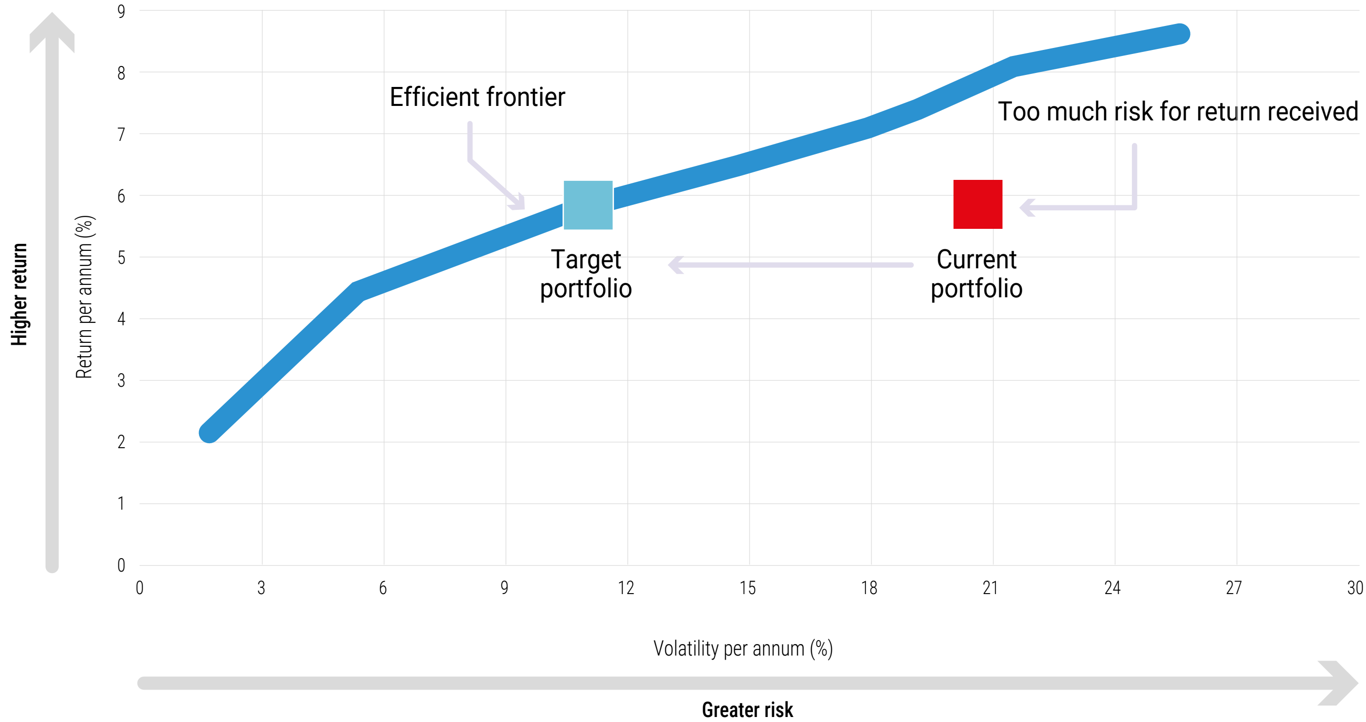
Rebalancing your portfolio to stay on track

Your needs and risk profile can change, especially if markets move sharply or your life circumstances change. That is why it is important to review and rebalance your portfolio regularly to make sure it still matches your goals and risk level.

Finding your best balance of risk and reward

The chart shows how the efficient frontier works.

- The **red** box shows a portfolio that is taking more risk than needed for the return it is getting
- The **blue** box shows a portfolio that is closer to the efficient frontier, delivering the same return, but with less risk



The right balance of risk and reward is personal. By understanding where your investments sit on the efficient frontier and diversifying well, you give yourself the best chance of reaching your goals without taking unnecessary risks.

Why does the efficient frontier matter to you as an investor?

- **Maximise potential returns for the level of risk you are comfortable with** - Avoiding investments that take on extra risk without offering better rewards
- **Avoid unnecessary compromises** – Ensuring your portfolio works as efficiently as possible
- **Stay focused on your plan** - Knowing where you sit on the risk/reward spectrum makes it easier to stick to your investment strategy through ups and downs
- **Personalise your investing** - The optimal portfolio for you might be very different from someone else's, depending on your goals, time horizon and tolerance to risk

Key takeaways

- Understanding your risk profile is essential before making investment decisions
- Diversification helps you get the best possible return for the risk you are willing to take
- Regularly review and rebalance your portfolio to keep it aligned with your goals and comfort level

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