It's been a volatile time on global investment markets, as shares and other assets are knocked about. At times like these it's little wonder that more cautious investors decide it's too risky to approach the start line.

No sensible person would take risks with their hard-earned cash for the sake of it, but the paradox of investing is that there's no avoiding risk if you want to achieve financial security.

Risk vs volatility

Investing is an inherently risky business, but perhaps not in the way you think. While it's common to hear people talk about volatility as a byword for risk, they are not the same thing.

In investment markets, volatility refers to daily price fluctuations. Risk, on the other hand, is the possibility that an investment will provide a lower return than expected over your time horizon or even a permanent loss.

Short-term volatility is only a risk if you need to sell investments after a big price fall. The longer your time horizon, the less important volatility becomes.

That doesn't mean you can afford to set and forget your investments. All investments involve some form of risk. Here is a rundown of some of the main types of risk:

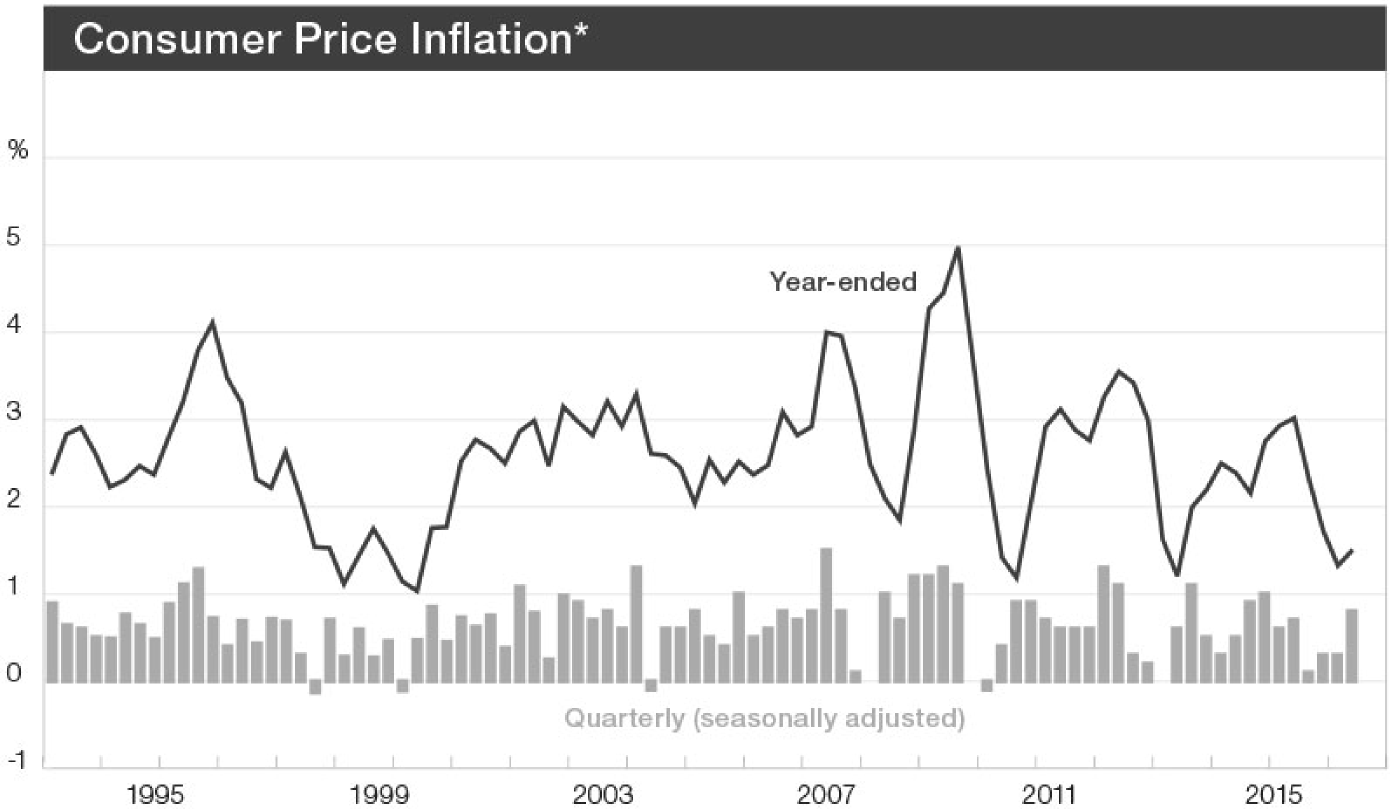
General market risk
This refers to the possibility that an investment will lose value because of a general decline in financial markets, due to one or more economic, political, or other factors. For example, during the global financial crisis share prices fell across the board. Market risk can cause problems for investors who need to sell assets into a falling market to raise cash, but it can also provide opportunities to pick up a bargain.

Economic risk
This refers to the possibility of an economic shock or crisis that will cause panic selling, such as a debt crisis or a credit squeeze.

Interest rate risk
When rates are low investors borrow to buy shares and property, pushing up prices. When interest rates rise it is more expensive to borrow money to invest in shares and property so they tend to fall in value, while bank savings accounts and term deposits become more attractive.

Exchange rate risk
Exchange rates add another layer of risk and complexity when you invest in international shares and funds or local shares with overseas operations. You can manage this risk to some extent by buying a hedged version of an overseas fund or shares in a local company that hedges its currency exposure.

Country risk
Sometimes particular countries face political or economic upheavals that spook financial markets. The Greek debt crisis and the Chinese sharemarket crash are two recent examples.



* Excluding interest charges prior to the September quarter 1998 and adjusted for the tax changes of 1999–2000

Sources: ABS; RBA

Inflation

Inflation is an increase in the prices of goods and services in the economy and goes hand in hand with growth. But if the return on your investments is lower than the rate of inflation your purchasing power will go backwards.

Sector risk

This applies to particular sectors of a market or economy. For example, the spread of the internet is disrupting the business model of companies in the media sector, while low commodity prices have hit companies in the resources sector.

Specific risk

This is the risk that a company you own shares in turns out to be a lemon. Or your investment property is in the path of a new freeway.

That may sound like a lot of risk, but without accepting some degree of risk you are unlikely to earn the returns you need to keep ahead of inflation and achieve your financial goals.

Risk tolerance

The amount of risk you accept depends on your personal tolerance for risk, your investment goals and the price you put on a good night's sleep. It will also depend on your time horizon.

If you are close to retirement, you may wish to reduce the overall risk of your portfolio to protect your capital. Even so, it's still wise to keep a portion of your money in higher risk investments such as shares and property to produce the returns you need to last the distance.

Given that today's retirees can expect to live well into their 80s, the biggest risk of all is the risk of outliving your investments, or longevity risk.

Diversification

You can't banish risk entirely but the good news is that most risks can be reduced or managed with some simple strategies. Understanding what you are investing in is important, but the simplest way to mitigate against risk is to avoid putting all your eggs in one basket.

Shares, property and bonds all perform well, or poorly, at different points in the economic cycle. So diversification across and within asset classes and geographic locations is the best insurance against a period of poor performance in a single investment or the broader market.

If you would like to discuss your risk tolerance in the context of your investment portfolio, don't hesitate to call.

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