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Understanding fund risks – nothing ventured, nothing gained

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In this blog we analyse the different types of risk that one should be aware of before investing in a fund. We show which considerations should be made regarding the time of entry and the investment period.

Return, security or availability?

When investing, investors find themselves caught between the conflicting priorities of return, security, and availability. Unfortunately, there is no such thing as an investment with full security, high returns, and availability at all times. As an investor, you have to make compromises in order to find the right form of investment for you. As a rule, the higher the possible return, the higher the expected risk and the longer the necessary investment period.

In the following we will take a closer look at the possible risks and the investment period in detail.

What are the risks of investing in funds?

The most important form of risk that investors feel most strongly about is market risk. This is the risk that the investment fund will lose value because the securities in the fund fluctuate in price.

Depending on the type of fund, a fund has more or less market risk – equity funds typically have a higher market risk than bond funds. A helpful indicator for assessing this risk can be the Synthetic Risk and Reward Indicator (SRRI). This is shown on a scale of 1 to 7 in the Key Information Document (KID). It shows how high the fluctuations of the fund unit price were in the past. Another measure is volatility, which can be found on factsheets.

In both cases, the higher the number on the scale or the volatility in percent, the higher the price fluctuations of the fund were in the past. Although this is not indicative of future price movements, these indicators can be quite helpful when comparing funds to understand how much the investment might fluctuate.

If investors prefer funds that focus on specific sectors or countries, specific sector or country risks for those areas come into play. For example, the sanctions related to the Ukraine war led to the suspension of trading in funds specialising in Russia.

The risks in this area are very diverse and are presented in the relevant fund documents. More broadly diversified funds also spread these risks, which means that the impact should not be as significant in the event of an incident.

Many funds invest in a broadly diversified manner and thus include securities listed in different currencies. For example, a global equity fund will hold stocks from America (e.g. Apple in USD), but also stocks from Europe (e.g. BMW in EUR) and stocks from Asia (e.g. Sony in JPY). Fund managers often buy shares in their local currency. This results in an additional currency risk. Since not only the prices of the securities fluctuate, but also the exchange rates of the currencies, this risk has a direct influence on the performance of a fund and is also actively managed by the fund managers. Even if investors buy the fund unit certificate in a certain currency, in Austria mostly in euros, this does not mean that there is no currency risk in the fund. As soon as the fund managers invest in securities outside the Eurozone, there is a currency risk.

Another risk that investors should be aware of when investing in funds is the issuer risk, which exists on several levels. In the case of direct investments in shares, a large part of the investment would be lost as soon as the issuer files for bankruptcy. At the fund level, investors are affected by this risk in different ways. On the one hand, funds are special assets that are strictly separated from the assets of the fund company that manages the fund or the custodian bank where the fund's securities are held. Even in the event of bankruptcy of the fund company or the custodian bank, the special assets remain available. However, since the fund assets themselves are invested in a large number of direct investments, the fund continues to have an issuer risk – even if this is greatly reduced compared to direct investments due to diversification.

Can I protect my assets against risks?

In short – no. Investing is always associated with risks. Investment forms that promise otherwise just don't show the risks for the most part. However, contrary to the general gut feeling, doing nothing and storing your money in a savings account or under the mattress is not risk-free either. Although one should keep small amounts on the savings account as a "nest egg" for unforeseeable expenses or liquid funds available at short notice, the risk of inflation comes into play with savings deposits, whereby the money loses purchasing power. Inflation has just become noticeable again in 2022, even in everyday life.

As mentioned at the beginning, the investment period can also have an influence on the possible return. The impact of many risks can be reduced by choosing an appropriately long investment horizon. In addition, the question of the "right" time to enter the market often arises, but this is difficult to predict. Therefore, it is advisable to invest smaller amounts over a longer period of time – e.g. through a fund savings plan with monthly payments starting at EUR 50. This approach has proven itself over the years. It offers the advantage of not having to invest the entire capital at once and thus also of being able to buy fund units more cheaply in the event of falling prices.

"Time in the market beats timing the market"

In summary: Fund investments are associated with different risks, which are presented in the fund documents. With a broadly diversified, actively managed mixed fund, risk management with regard to markets, sectors, countries and currencies is left to experienced fund managers. Even if they cannot always guarantee increases in value, the risk of the investment is reduced with a correspondingly long investment period and diversification of the time of entry.

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