

RISK MANAGEMENT

What is portfolio risk?

Portfolio risk can be defined as the risk that a portfolio will fail to meet its overall objectives or expectations. There are many potential sources of portfolio risk, some of which are extremely difficult to control such as an unexpected event which triggers a market crash. Risk is an inherent part of investing, but it can be more successfully managed by matching an investor's risk profile to the investments and allocations within their portfolio.

Portfolio concentration

The risk arising from a portfolio being overly concentrated in any single asset (or group of assets) is known as concentration risk. By allocating the portfolio across a range of different assets, the reliance of the portfolio on any one investment is reduced and portfolio returns are less likely to be significantly impacted by a single poor-performing asset. Put simply, concentration risk is the risk of "putting all your eggs in one basket".

By diversifying a portfolio across different geographies, sectors, styles and asset classes, the overall risk of the portfolio can be reduced for any given level of expected return. This is why diversification is often referred to as "the only free lunch in finance."

Adding highly diversified index strategies (such as exchange traded funds, or ETFs) to a portfolio, across different asset classes, is a simple and effective way to reduce concentration risk. Each individual ETF gives the investor exposure to a large number (sometimes hundreds) of underlying securities, and the many different ETF products offer a broad range of different global, regional, country and industry exposures. For example, with the iShares S&P Global 100 (ASX: IOO) investors can diversify internationally across the world's largest companies including Microsoft, HSBC, Nestle and General Electric with just one trade.

Active manager risk

Having decided upon a diverse strategic allocation for their clients' portfolios, many advisers will then include active investment managers within specific asset classes with the aim of generating additional active returns. These managers seek to actively pick securities within their designated asset class in the expectation of outperforming the broad benchmark index. In doing so, however, the portfolio will experience more volatile returns and likely incur higher costs associated with active management. Balancing this relationship between additional expected return and risk, while also considering additional costs is essential to developing a well constructed portfolio.

A common strategy to manage the additional risk and costs associated with hiring active managers is to blend a mix of active and index investments. The diversification of ETFs will reduce portfolio risk relative to the benchmark, while the low management fees and transaction costs associated with ETFs allows total portfolio expenses to be controlled.

Asset allocation drift

Another common source of portfolio risk is the volatility caused by a portfolio drifting away from its long-term strategic benchmark. As the portfolio allocations move away from the strategic mix, portfolio performance will differ from that of the benchmark, causing volatility (or risk) to the portfolio relative to its long-term target. The more the portfolio weights are allowed to drift, the less likely the portfolio's risk profile matches that of the investor.

ETFs provide simple, diversified and cost-effective exposures to a wide range of regions, countries and sectors, allowing portfolio allocations to be kept within acceptable tolerances with operational ease. This is why ETFs have become a very popular for rebalancing and managing portfolio drift.

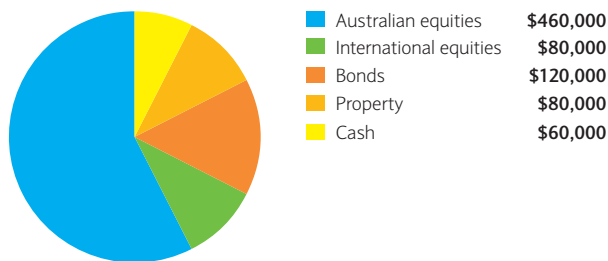
Client case study – Tom and Sonya

- **Age:** 40s
- **Portfolio:** 90% Australian, 10% international
- **Interests:** children, fitness
- **Goal:** decrease their portfolio risk through diversification

Meet Tom and Sonya

Tom and Sonya have a portfolio consisting of 90% exposure to Australian equities and bonds, and 10% to international equities through actively managed funds. After recent market volatility, their adviser has recommended Tom and Sonya review their portfolio risk management strategy.

Tom and Sonya's SAA



Factors important to their decision:

- **Cost:** they are looking to de-risk their portfolio without it being an expensive exercise.
- **Single stock risk:** they want further international exposure without choosing single stocks.
- **Liquidity:** Having had managed funds frozen, they want to make sure they can get in and out of any investment as they please.

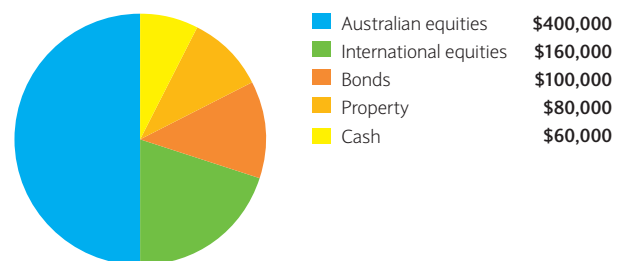
Working with their financial adviser

Tom and Sonya's adviser reviews their risk profile with them. Because their portfolio is heavily weighted to the Australian market their adviser suggests they incorporate a broader global market allocation.

Their adviser explains that because ETFs provide a basket of shares in one trade, there is no requirement to choose single stocks. Tom also prefers that unlike managed funds, ETFs cannot be frozen. They choose to invest in two ETFs; the iShares S&P Global 100 (ASX: IOO) and the iShares MSCI Emerging Markets (ASX: IEM). These ETFs provide over 400 companies across more than 20 countries, combining the top 100 global companies including Microsoft and Nestle, with the growth potential of the emerging economies.

On the advice of their adviser, Tom and Sonya sell \$20,000 of bonds and \$60,000 of Australian equities to make the investment into ETFs. Their new portfolio is 80% Australian and 20% international, which better matches their risk profile and allows them to better manage risk in their portfolio.

Tom and Sonya's new portfolio



The outcome

Good for the client:

- ✓ Able to further diversify risk using different countries, companies and industries.
- ✓ They like the flexibility of the iShares ETF to rebalance easily and cost-effectively when needed.
- ✓ Fees are much lower than expected, and even cheaper than domestic managed funds.

Good for the adviser:

- ✓ Client is happy with the solution.
- ✓ Diversified active manager risk for the international allocation by using best new tools.
- ✓ Greater control over several risks in the portfolio as well as costs.

For more information visit [iShares.com.au](https://www.ishares.com.au) or call 1300 iShares (1300 474 2737)

Important information

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