

4. Risks of super

The information in this document forms part of the Product Disclosure Statement (PDS), dated 6 February 2012, for the LGS Accumulation Scheme. This document is dated 6 February 2012.

Overview

There is a relationship between the amount of risk a person is willing to take and the potential return they may get on their investment.

In general, investments which potentially earn higher long-term returns (i.e. shares and property) carry higher short-term risk. Not only may the rate of return of the investment vary, but also the value of the investment can rise and fall more sharply than other investments.

Typically, investments that potentially earn lower longer term returns (i.e. cash, fixed interest and bonds) are likely to fluctuate less in the short term.

Factors such as interest and exchange rates, government policy and the state of domestic and world economies will impact on the financial and investment markets and therefore your investment. In the case of listed securities such as shares and listed property trusts, other influences include political events and the performance of world share markets. It is important to note that the returns from listed investments reflect the market forces of supply and demand and investor sentiment.

The principle of diversification is that you spread your investment between more than one asset class. The intended result is to achieve more stable investment returns. In other words, the total returns of a diversified portfolio should not fluctuate as much as the returns from investing solely in one asset class.

Local Government Super adds further diversification by spreading money across a group of specialist fund managers.

Investment returns in recent years

Up-to-date information in relation to the annual effective net earnings for each investment option over the last five financial years is set out in the latest Annual Report, along with other related investment performance information.

You should note that the net earning rate reported in the Annual Report may not be the same as the rate experienced by members, because of timing differences and the reserving policy.

You should be aware that past net earning rates are not a reliable indicator of future net earning rates. More information about investment returns is available from the LGS website.

Risk of investing

In general, investments looking to generate the highest returns tend to have the highest risks. "Risk" means not only that returns might be variable (or 'volatile'), but that part or all the

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investment might be lost. Historically, shares have been more volatile than other investments, such as property or fixed interest.

Regardless of the investment option chosen, the value of your investment can fall as well as rise. Even where your investment does not fall in value, it may not perform according to your expectations.

Inflation risk

A further risk is inflation. Although the investment may produce a positive return, when we compare this to the increase in the cost of living, you may find that your return hasn't kept up with inflation, effectively reducing your purchasing power. You need to balance risk against returns in order to achieve your investment goals.

Credit risk

Investment in debt securities or other debt instruments can be subject to default risk. For example, where we buy a Bond that has a regular coupon (interest) payment and a capital repayment (the money you get at the end of the period of the bond), there is a risk that the organisation that issued the bond (credit issuer) may default on the interest payments, the capital repayment or both.

Bond investments with a non-investment grade credit rating (that is Standard and Poor's BB+ rating or an equivalent rating from another agency, or less) are subject to increased risks, compared with investment grade securities – rated AA for example. The credit issuer of a lower graded bond may be more likely to default on the interest payments, the repayment of capital or both. However it is more likely that these debt securities may provide a higher return, and we may still invest in lower grade securities.

Interest rate risk

Cash, cash-like securities and debt securities investments are affected by interest rate movements. Capital gains can be earned from debt securities investments where interest rates are falling and capital losses can occur when interest rates are rising. The risk of capital gain or loss tends to increase as the term to maturity of the investment increases.

Liquidity risk

Many investment options hold assets which are 'illiquid'. If we invest in illiquid assets, we may not be able to sell the investment at short notice, or we may need to sell our investment at a discount or a loss if we need to 'cash out' quickly. Examples are direct property, absolute return, private equity and non-listed alternative investments. Listed investments can also be illiquid where there is not an active market for the securities such as small companies' shares.

Diversifying across a range of investments and limiting holdings in potentially illiquid investments may help you manage the risks of illiquid investments.

Market risk

General economic conditions both in Australia and elsewhere in the world affect markets. Changes in government policies, interest rates, inflation, technological developments and demographic changes (alterations in the make-up of the population – such as the fact that on average the population of Australia is ageing) all affect investment markets as a whole, causing the value of investments to rise and fall. We have no way of accurately predicting what will happen and how this will affect the markets.

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Derivatives risk

The Trustee has a policy that is applied when approved investment managers trade in derivatives. This policy includes guidelines for writing and buying 'options', 'futures' and other derivatives. Derivatives can be used for many purposes, including hedging to protect an asset against market fluctuations, reducing costs of achieving a particular market exposure and maintaining benchmark asset allocations. Risks include:

Price – The risk that changes in prices in the market underlying a derivative contract, or in the derivative contract itself, are adverse to the position held.

Leverage – The risk that by creating greater exposure to a market than that of the assets backing the position, losses will be magnified.

Liquidity – The risk that a derivative position cannot be reversed.

Default – The risk that the other party does not meet its obligations.

Short selling risk

Short selling is a sophisticated technique where a share or bond is sold, for delivery at a later date, in anticipation that its value will decline over the period, and you will be able to buy it back at a cheaper price than you sold it. Of course if the price has gone up you can lose the difference between what you sold it for and what you need to buy it for (plus all the transaction, holding and other costs).

Currency risk

A portion of LGS's assets are invested internationally and therefore can be affected by currency movements.

As part of the Trustee's policy, all investments are fully hedged, while a currency manager is employed to put a passive hedge in place for LGS's international equity investments. This hedge position may move from time to time, but for benchmarking purposes a 50% hedge ratio is used.

Asset class risk

Risks for individual asset classes include:

Alternative assets – these assets can involve exposure to all of the risks applying to the traditional asset classes described in this fact sheet. In addition, many alternative assets are illiquid and can also involve the use of derivatives, gearing and short selling.

Australian shares – Specific risks relating to individual companies include profits and dividends being below expectations, adverse management charges or reassessment of the outlook for the company or industry.

Cash – Whilst it is unlikely that the market value of a cash investment will decline, longer-term returns are generally lower than other assets.

Debt securities – These investments normally pay a set amount of interest income over time but their market value can fluctuate. Overall returns over short-term periods can be negative. The value will fall if yields rise. Fixed interest investments are also subject to default risk.

International shares – Global economic trends, individual country risk factors as well as specific risks relating to individual companies will affect the price. There is also currency risk (unless hedged).

Capital gains may occur when the Australian dollar depreciates against other currencies and the capital losses may occur when the Australian dollar appreciates.

Property – Risks include vacancies, locational factors, unprofitable property development activities, declining property values and realised losses when properties are sold where the property investments are held in a listed entity. It will also attract some of the risks

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associated with share market volatility. Other risks include delays in obtaining required approvals, construction, leasing and market risk.

How do I understand and manage my risk?

Whilst you can never fully eliminate the risk associated with an investment, there are a number of different ways in which you can minimise the potential risk.

Obtain professional advice

Investments are complicated and although the risk profile of an investment may be an indication, it is recommended that you seek professional advice before deciding which investment option best suits your needs.

Regularly review your investment

Your individual circumstances may change and as a result your selected investment may no longer be suitable. If you do think that your investment is no longer best serving your needs, you should obtain professional advice to review your investment choice.

Invest for the long term

Superannuation is a long-term investment and moving between investments on a regular basis may do more harm than good. You should consider remaining in your selected option for at least the minimum investment timeframe suggested for the investment option.

Note: Investing for the suggested investment timeframe will not eliminate the risk.

Read all of the information

It is important that you read all of the information associated with the investment. Risk profiles can be an indicator as to the volatility of an investment, but you should also be aware of where your money is being invested to understand how the various risks may have an impact on your investment.