What types of assets a fund may invest in?

Subject to the fund investment objective, a fund may invest in equities, bonds, derivative instruments or a combination of these financial instruments in one or various markets or directly invests in other funds.

What sorts of risks are associated with different kinds of assets?

For equity investment, the most common risks are unsystematic risk, which affects specific companies only (e.g. a competitor company launches new products and hence the original market share is threatened) and systematic risk, which impacts the overall markets (e.g. financial turmoil in 2008).

Major risks related to bonds include interest-rate risk, inflation risk, default risk, duration risk and counterparty risk. Interest-rate risk means when interest rates go down, bond prices usually go up and vice versa. Duration refers to the time period before bonds mature. Bond prices may be affected by many factors within the duration. If investors sell the bond before its maturity when the bond price is impacted negatively, investors may be subject to the risk of decline in investment value. Default risk relates to the possibility of an issuer failing to pay interests or repay the principal; inflation risk occurs when the total returns of investors' investment fail to keep pace with the inflation rate. Counterparty risk happens when a 3rd party company which acts as contracting party of the bond issuer fail to live up to its contractual obligations and induce losses to the bond issuer.

Investors may be exposed to currency risk if the fund invests in overseas securities or the fund is not denominated in investors' home currency. Some funds may use hedging strategies to reduce the currency risk. Besides, investing in emerging markets, particular sectors or bond funds may be subject to liquidity risk. Since those markets or sectors are limited in size or lack of active and liquid secondary markets, it could impact the speed and prices for the realization of such investments. Besides, emerging markets may incur higher political, economic and social risks than developed markets.

Investing in financial derivatives is far more complicated. Derivatives are financial contracts, or financial instruments whose values are derived from the value of their underlying assets, including equities, commodities, bonds, loans, or underlying index. Investment in derivatives generally allows an investor the right to subscribe/sell a fixed number of assets at a pre-determined price on a future date or during a fixed period of time. If the price of the underlying asset moves to the expected direction, derivatives effectively lock up the future price of the underlying assets and offset the negative impacts of the future price change, which makes derivatives a useful tool for either hedging or increasing returns. However, investing in derivatives could also potentially be exposed to significant risks and losses should the market move against it. Derivative instruments may give rise to leverage which may cause fund price to be more volatile. Besides, derivative instruments may involve counterparty risk and liquidity risk. Since derivatives are relatively speculative in nature, both the risk and potential return of such investment would be higher than conventional equities and bonds.

Are there ways to avoid risks?

When investing, investors cannot totally avoid risks. However, once investors have identified the risks, investors can take steps to manage them and limit investors' exposure to a level acceptable to investors. One possible way to manage risk is to diversify.

With globalization, new risks may emerge. For example, the representation of credit rating is gaining more attention since the recent credit crunch. Investors must understand the full risk exposure before making an investment decision. A good place to start is to read the offering document of the fund that investors are interested in.

(Investment involves risk. Please refer to the offering document for further details including the risk factors.)

Hong Kong Investment Funds Association