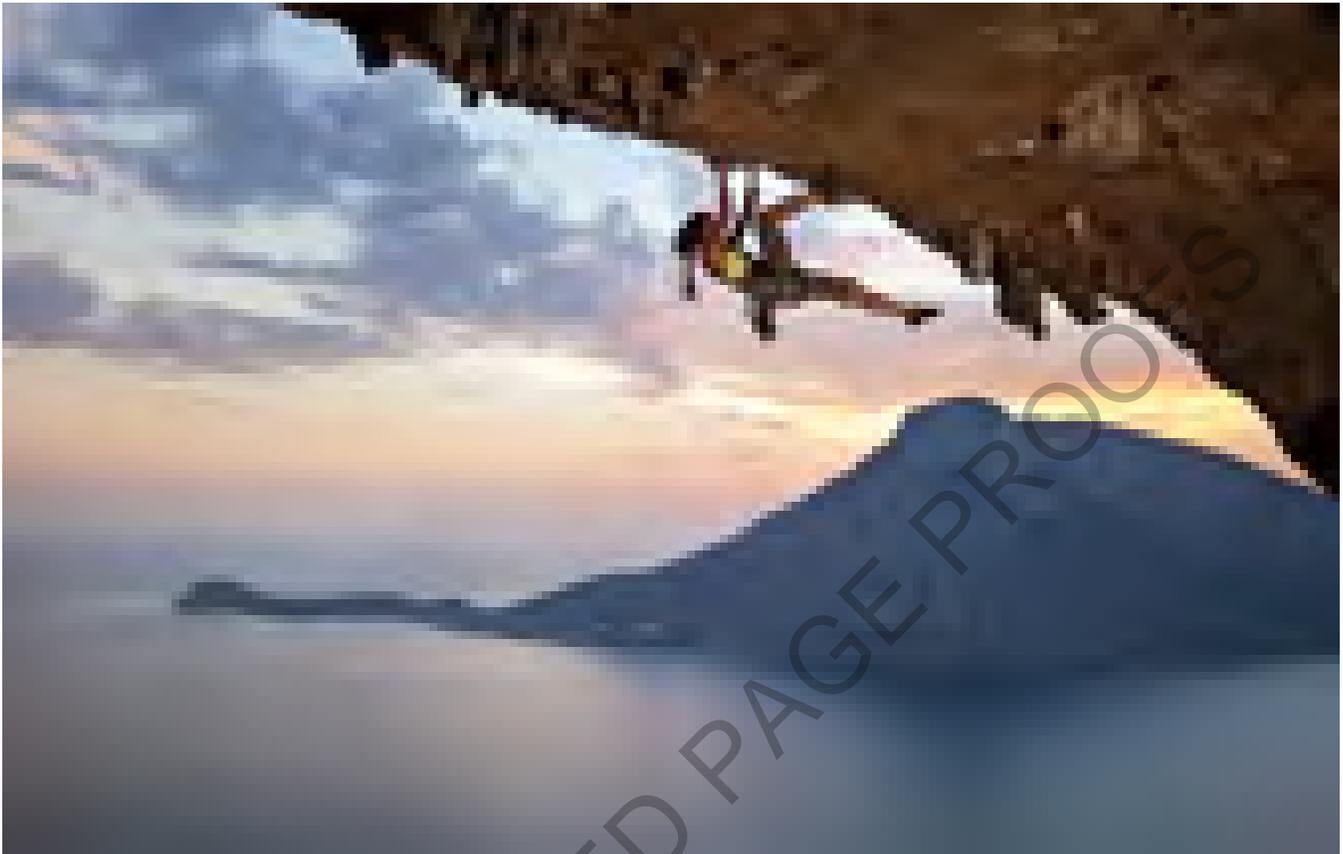


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## 3 Managing financial risk



### 3 Managing financial risk

#### 3.1 Overview

##### Managing risk

#### 3.1.1 Balancing risks and rewards

Rock climbing is a risky activity. If you do it with no safety equipment, your risk of having a serious accident increases. Wearing safety equipment minimises the risk, but it is still not as safe as staying on the ground. However, staying on the ground can be less rewarding than climbing. Like rock climbing, making financial decisions can be risky but those risks can be minimised. A wise money manager knows that making financial decisions requires balancing the financial risks against the rewards through appropriate risk-management strategies.

**Figure 1** Like rock climbing, financial decisions involve risks and rewards.



### 3 Managing financial risk

## 3.2 The role of banks and other deposit-taking institutions

### 3.2.1 The changing nature of banks

The Australian banking system has undergone great change over the last 30 years. Commencing with **deregulation** in the 1980s, the federal government removed many of the rules controlling the banking sector. Foreign banks were allowed to enter the Australian market and greater competition was encouraged. A wide range of institutions now offer financial products to customers. They include banks, building societies, credit unions, finance companies, superannuation funds, friendly societies and life insurance companies.

The Australian Prudential Regulation Authority (APRA) oversees authorised deposit-taking institutions (ADIs): banks, credit unions and building societies. ADIs are authorised to take deposits from customers under the *Banking Act 1959*. Deposit-taking institutions pool these deposits. This means they put them together and then lend them to individuals and businesses in the form of loans and **mortgages**.

**Figure 1** Deregulation of the banking sector in Australia has allowed foreign banks to enter the market and compete with local banks.



### 3.2.2 Banks

Banks offer a wide range of financial services to all participants in the Australian economy — accepting deposits; offering credit cards, cheques, overdrafts, investment and savings accounts; and lending money through personal and business loans and mortgages. Banks also provide other typical banking services such as internet banking, automatic teller machines (ATMs) and financial advice.

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**Figure 2** Providing ATMs is one of the many services offered by banks.

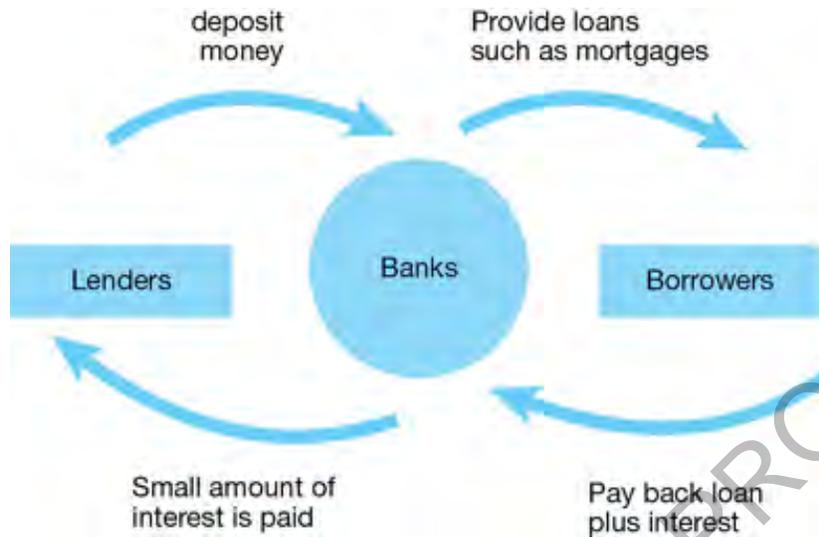


A bank savings account is an easy and safe place for people to keep their money. This type of account allows you to deposit money and make withdrawals. In return for your deposits, the bank pays you money known as **interest**. The amount of interest paid depends on the type of account, the number of times interest is paid into the account each year and the amount of money in the account.

A bank is a business that wants to make a profit, so it accepts money as savings (deposits) at a lower interest rate and lends that money at a higher interest rate. You may receive interest of between 2 and 4 per cent from the bank on your savings account, but the bank will charge between 5 and 15 per cent interest to those who borrow money. The difference between these two rates of interest is one of the ways a bank makes a profit.

---

**Figure 3** Banks act as intermediaries between lenders and borrowers.



### 3.2.3 Credit unions

A credit union is a financial institution that is owned and operated entirely by its members. Credit unions provide a range of products and services that are similar to those offered by banks. These include accepting deposits, offering personal and home loans, and providing payment services such as credit cards. To open an account with a credit union, you have to be an 'eligible' member. Every credit union has its own rules for determining eligibility, but it sometimes means that you have to belong to an industry affiliated with the credit union or be related to an eligible member. Because a credit union is focused on the financial wellbeing of its members, maximising profit is not its main objective.

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**Figure 4** People's Choice Credit Union is owned by its members. Its purpose is to help members save and borrow money.



## 3.2.4 Building societies

Like credit unions, building societies are owned and operated by their members. As their name suggests, building societies historically supported their members in purchasing homes. In more recent times, building societies have expanded to offer similar services to banks. As deposit-taking institutions, building societies accept deposits from customers and provide loans and payment services. There are now less than ten building societies in Australia because many of them converted to banks or merged with banks.

LEARN MORE

Go to your Resources section for

**Weblink:** [APRA](#)

**Figure 5** Building societies originally helped their members to buy homes but over time they have become more like banks.



3 Managing financial risk

## 3.3 Different types of investment

### 3.3.1 Saving for the future

There are many different types of investment that enable people to accumulate savings for the future. Some Australians choose to buy properties (such as a house, apartment or land) as investments. As property prices generally increase over time, so too does the value of their investment. Others choose to buy shares or invest in term deposits or managed funds.

**Figure 1** The largest investment most people will ever make is buying their own home.



Property prices have risen substantially in the last 20 years, to the extent that many people are now priced out of the suburbs where they would like to live. Do you think property should be seen as an investment to accumulate savings? **[Personal and social capability]**

### 3.3.2 Shares

Buying **shares** means buying a certain number of units of ownership in a company. This makes you a shareholder of that company. Some people might buy thousands of shares, others only a few. As the value of a company's shares goes up or down, so too does the value of the shareholder's investment. Owning shares allows you to benefit from the company's profits, which can be given to you as **dividends** or as extra shares. You may also benefit from **capital growth** if the value of your shares increases.

**Figure 2** The electronic display board of the Australian Securities Exchange shows the prices of shares traded on that exchange.



The image shows a large electronic display board at the ASX. The board is divided into columns with the following headers: STOCK, BID, OFFER, LAST, VOL, STOCK, BID, OFFER. The data is presented in a grid format with various stock names and their corresponding bid and offer prices. The ASX logo is visible in the top left corner of the display.

STOCK	BID	OFFER	LAST	VOL	STOCK	BID	OFFER
ARMSTRONG	0.000	0.000	0.000	0	FARM PRICE	0.100	0.140
ASX	0.000	0.140	0.000	0	FE LIMITED	0.028	0.030
ASX	0.000	0.000	0.000	0	FEDAX	0.120	0.130
ASX	0.000	0.000	0.000	0	FERRUM	0.024	0.033
ASX	0.000	0.000	0.000	0	FERRUMWEST	0.052	0.057
ASX	0.000	0.000	0.000	0	FIDUCIAN	0.800	0.810
ASX	0.000	0.000	0.000	0	FEAX	0.110	0.125
ASX	0.000	0.000	0.000	0	FINEAR	1.075	1.080
ASX	0.000	0.000	0.000	0	FINDERS	0.200	0.220
ASX	0.000	0.000	0.000	0	FIRSTSTONE	0.008	0.009
ASX	0.000	0.000	0.000	0	FIRSTSTATE	0.014	0.015
ASX	0.000	0.000	0.000	0	FISCOM EN	0.020	0.035
ASX	0.000	0.000	0.000	0	FITZROY	0.048	0.068
ASX	0.000	0.000	0.000	0	FLATIRON	0.225	0.230
ASX	0.000	0.000	0.000	0	FLATIRON	0.050	0.190
ASX	0.000	0.000	0.000	0	FLYDUTY	10.21	10.23
ASX	0.000	0.000	0.000	0	FLYDUTY	3.360	3.370
ASX	0.000	0.000	0.000	0	FLYDUTY	24.89	24.90
ASX	0.000	0.000	0.000	0	FLYDUTY	0.084	0.084

Buying and selling shares takes place in the **sharemarket**. In Australia, such transactions take place through the Australian Securities Exchange (ASX), which was formed in 1987 by amalgamating the six capital-city stock exchanges. A stockbroker has direct access to the market for trading shares and, for a small fee, acts as an **agent** to buy and sell shares. This fee is known as brokerage.

**Figure 3** On the Australian Securities Exchange, shares can be purchased in companies such as Telstra, Qantas and Woolworths.



It is important to diversify your investments so that all your 'eggs' are not in one basket if anything goes wrong. The Australian sharemarket makes this easier by offering a wide choice of companies in which to invest. There are over 2000 companies listed on the ASX. These companies are involved in a wide range of industries covering most sectors of the economy, from financial services to industrials and healthcare. Investing in a range of companies spreads the risk. Investing in shares also gives you flexibility. Shares can be bought and sold quickly — you can sell shares and generally have access to your money in three days or less.

### 3.3.3 Term deposits

One place to keep large sums of money is in a fixed-term deposit. All major banks offer term deposit accounts where you can place your money for a fixed period of time. The time can range from one month to five years. The banks offer a higher rate of interest on such deposits compared with at-call deposits that can be withdrawn at any time.

Term deposits are considered to be low-risk investments because the bank assures the return, but the return tends to be lower than that obtained from owning other types of investments such as shares. The funds in the term deposit are locked away until the end of the term unless you choose to make an early withdrawal, in which case penalty fees will be charged. You therefore need to select an account whose term and rate of interest best suit your needs.

### 3.3.4 Managed funds

Some people choose to invest in managed funds. These are portfolios of shares, property, public infrastructure, private equity and other investments that are chosen by a professional fund manager. Investing in a managed fund spreads the risk over different types of investment. Decisions about what to invest in are made by a professional, but this also means that investors have no say in the fund's investment decisions.

Most funds have entry and exit fees, and some have monthly fees. It can also be difficult to access your money quickly. Investing in a managed fund is therefore a good choice if you are happy to put your money into an investment and leave it there for a long period.

**Figure 4** In a managed fund, a professional fund manager invests the money pooled from many individual investors into a range of assets, including shares and property.



## 3.4 Protection from financial risk

### 3.4.1 Looking after your money

People invest in order to earn a positive return on their money. Making any sort of investment involves a **financial risk**. Some financial decisions can have completely unexpected or unwanted outcomes. Thankfully, there are ways that consumers can protect themselves against risks.

**Figure 1** Protecting yourself from financial risk when making an investment is like having a lifebuoy aboard a ship in case it hits rough water and capsizes.



### 3.4.2 Financial risks

There are many types of financial risk (see figure 2). The basic risk is that the value of the investment will fall and the person making the investment will lose everything. Note that making any sort of investment involves a risk. The only way to avoid risk altogether is to not invest money at all. However, doing so means that you miss out on any potential rewards.



Types of financial risk

Interactivity: [Types of financial risk](#)

Scams and identity theft are also financial risks. Let us examine these two financial risks in a little more detail.

## Scams

A scam is a dishonest scheme to trap you into parting with your money. The range of scams is limited only by the imagination of scammers themselves. Generally, scams fall under two categories:

- an attempt to convince you to send the scammer money in return for the promise to do something — a promise the scammer never intends to complete in full if at all
- the use of unscrupulous means to gain access to your personal details such as credit card information, bank account numbers and passport details. This is referred to as identity theft (examined in more detail in the next section).

Some common scams are shown in [figure 3](#).



Some common types of scam

[Interactivity: Some common types of scam](#)

Scams are often successful because they look genuine. Scammers are also very skilled at manipulating people emotionally. To avoid being a victim of a scam, you should make the effort to research any offers made to you. Always ask questions and think carefully before making any decision.

## Identity theft

Identity theft is a growing problem worldwide. It occurs when someone illegally obtains your personal details, such as bank account numbers, and uses those details to commit **fraud**. The identity thief uses your stolen identity to do the following things in your name:

- borrow money
- open a new credit card account
- buy goods.

Anyone who provides personal information to an unsecured website when shopping online risks becoming a victim of identity theft. If the online seller asks you for additional information such as your email address or phone number, do not provide them unless you are confident the seller can be trusted.

A growing number of consumers have had their identity stolen through phishing. In this type of fraud, you are sent an email that looks like it comes from a trusted source such as a bank. The thieves ask you for information that may seem reasonable, such as your account number and PIN (personal identification number). To avoid being a victim of phishing, you should be suspicious of any email that makes an urgent request for your personal financial details. Do not click on links within the email or reply to any pop-up screen that asks you for personal details.

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**Figure 4** Identity theft can result in your entire identity being assumed by a scammer who might use it to open bank accounts, obtain loans or credit cards, or conduct other illegal activities — all in your name.



### 3.4.3 Protecting yourself from financial risk

There are many ways that consumers can protect themselves from financial risk:

- Make informed decisions and seek advice from qualified financial advisers.
- Be aware that all investments involve some level of risk, and understand the need to weigh up risk and return.
- Diversify by investing in a wide range of assets. You could invest in several different shares and have the rest of your money split between term deposits, property and managed funds.
- Have insurance, savings and superannuation. This is examined in the following section.

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**Figure 5** One way of protecting yourself from financial risk is to invest in a range of different assets with varying levels of risk.



## Insurance

Taking out **insurance** protects you financially from any unexpected losses. Some common types of insurance are illustrated in figure 6.



Types of insurance

[Interactivity: Types of insurance](#)

## Savings

You can reduce financial risk by having savings — funds from which to draw when things go wrong. (Savings are discussed in more detail in [subtopic 3.5](#).) You save by earning more money than you spend. Savings are usually kept in savings accounts, term deposits or any of the other investments explored in this topic. As the case study 'Australians struggling to save' explains, recent research indicates that many Australians struggle to save any money.

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## Case study

### Australians struggling to save

A June 2014 report by ME Bank revealed that many Australians are finding it hard to save cash at the end of each month. The Household Financial Comfort Report showed that in June only 46 per cent of the 1500 households surveyed were able to save. This was the lowest percentage since ME Bank's first biannual survey in October 2011. For the households able to save each month, the amount they were saving fell by 12 per cent.



Approximately 42 per cent of families broke even at the end of the month and 12 per cent overspent, drawing on savings, loans or home equity. The households overspending increased their spending by 13 per cent. Almost one-quarter of the households surveyed said they would not be able to raise \$3000 in an emergency; this was a rise of 6 per cent. The bank's economic consultant, Jeff Oughton, said that

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'households are most uncomfortable with their amount of savings, in both normal times and in cases of an emergency.'

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## Superannuation

When a person retires, they may be able to access an **age pension** in order to survive. This is an amount provided by the federal government to help an elderly person meet their basic needs. It does not allow for a luxurious or comfortable lifestyle, especially if debts have been accumulated. Although the government does provide a pension, it is not always sufficient to maintain a preferred lifestyle. As a result, a person may need to work longer or sell assets in order to generate the cash flow required.

You can make sure that you have a good lifestyle in retirement, and protect yourself from having to watch every dollar you spend, by taking advantage of **superannuation**. This is a compulsory savings scheme whereby employers contribute an additional percentage of an employee's **gross wage** into a **superannuation fund**. Employees can also choose to contribute to this fund, thus increasing the overall amount they will receive on retirement. How much employees choose to contribute is up to them. There are laws in place that determine when you are eligible to access your superannuation savings. Recent changes have made it attractive to remain working until at least age 60.

### 3 Managing financial risk

## 3.5 Managing debt

### 3.5.1 Making good decisions

Are you the type of person who burns through their money fast? Money is great to have but it won't last long unless you make wise choices. If you keep track of your money and spending habits, you can become a wise money user and make your money work for you. Continuing to borrow money can land you in trouble.

**Figure 1** The temptation to spend money is everywhere.



### 3.5.2 Good and bad debt

When you borrow money or owe money to someone, you are said to be in **debt**. You have a financial obligation to repay the borrowed money. Debt can be a good thing if it is used to leave you better off in the long-term. A mortgage, where you borrow money to purchase a home or property, is an example of good debt. Taking out a student loan or a loan to start a new business are also examples of good debt. These are borrowings to invest in assets that will grow in value over time.

Some adults and young people get into a lot of debt. Reasons for this include unemployment, illness, the rising cost of living, gambling and the overuse of credit cards. Unfortunately, instead of reducing expenditure and paying off debts, there is a temptation to borrow more money. This can lead to out-of-control or spiralling debt.

**Figure 2** Excessive debt can cause stress, reduce savings and affect your ability to borrow money in the future.



The bad news is that the consequences of debt can be very serious. A person who cannot keep up with payments for the purchase of a car, for example, faces having the vehicle **repossessed**. They may get some of their money back, but there is no guarantee.

In really serious situations, a person who has many debts and no way of repaying them faces personal **bankruptcy**. This is a formal, legal way of saying that the person 'cannot pay their debts'. The period of bankruptcy usually lasts for three years, but it can affect the rest of your life. Some consequences are:

- Your credit rating is affected and you may find it difficult to borrow money.
- It can affect employment opportunities.
- Your residence may have to be sold to help pay your debts.

### 3.5.3 How to manage debt

Now for the good news! There are steps you can take to overcome being in debt. The first step is to face up to the problem instead of hoping it will go away. Make a list of your essential expenses and those that are

optional. Avoid spending money on optional expenses. Buy only what you can afford without having to borrow. Lastly, work out a plan to repay the debt and stick to it.

**Figure 3** Gabrielle is aged 14 and in debt. She borrowed \$40 from her brother for some clothes she 'just had to have'. Now she has discovered she owes \$100 for call costs from her mobile phone. She feels sick with worry and is scared to tell her parents.



### 3.5.4 Saving

There is no mystery about managing money, managing debt and building personal wealth. It's just a matter of regular saving. You can save money if you have more money coming in than you have going out. It requires only a simple maths calculation to work it out:

$$\$40 \text{ income} - \$20 \text{ expenses} = \$20 \text{ remaining that can be saved}$$

Wise money managers know that saving money:

- gives you more independence and security
- gives you a sense of satisfaction
- helps you pay for unexpected expenses
- avoids the need to borrow money and the worry about repaying the debt
- helps you plan for buying big items, such as a bike or a car.

It is easier to save money if you have clear financial goals in mind. The good thing about setting goals is that they give you a purpose for saving. Goals should be realistic and specific. For example, your goal might be 'to save \$100 in six months to reduce my debt.'

Many people wish they were better at saving their money. How do you deal with the temptation to spend versus the desire to save? Do you have any tips for how to become a more effective saver? **[Personal and social capability]**

Saving money is a bit like an exercise program or a diet. You have to have a plan and stick to it to make a difference. You should aim to save a minimum of 10 per cent of your income. That means you should put aside 10 cents out of every dollar you earn. Alternatively, you might decide to save a specific amount, such as \$10 per week.

Use the following steps in [figure 4](#) as a guide to work out your savings plan.

UNCORRECTED PAGE PROOFS

Figure 4 Developing a savings plan



UNCORRECTED PAGE PROOFS

Once you have made the decision to develop a savings plan, your debt should gradually fall. When you have reduced your debt to a satisfactory level, an easy and safe place to keep your extra money is in a savings account. When your savings have built up, you may wish to consider other forms of investments, such as term deposits, managed funds, shares or property.

### 3 Managing financial risk

LEARN MORE

Go to your Resources section for

**Weblink:** MoneySmart savings goal calculator

## 3.6 SkillBuilder: Reading a sharemarket chart

### 3.6.1 Tell me

What is a sharemarket chart?

A sharemarket chart provides information on how shares are performing. It is one form of reporting changes in the sharemarket. Sharemarket charts are available in newspapers, on television and radio news and on the internet. Many factors are included in a sharemarket report, and not all media may provide data on the same factors. An example of a sharemarket chart is shown in figure 1.

Some of the factors included in charts and other reports are: information on share prices, changes in price and percentage price changes. For example, when a sharemarket chart mentions 'net change', it is referring to the difference between the current end-of-day share prices and that of the same share on a previous day.

Other factors that a sharemarket chart usually includes are the share names, symbols, dividend rates and percentage yields. The dividend rate refers to the return per share a company pays to shareholders over a given period, while the percentage yield refers usually to the annual income per share, expressed as a percentage of the cost of the share.

Reading a sharemarket chart

[Interactivity: Reading a sharemarket chart](#)

Why are sharemarket charts useful?

Just as a weather report informs people about conditions outside and helps them decide whether to put on a coat (or take off their jumper) for outdoors, similarly a sharemarket chart tells you about the conditions in the sharemarket but helps you decide whether to buy (or sell) shares.

An important reason why an investor should be able to read a sharemarket chart is that it provides important information needed to make decisions about investments. Information about movements in shares enables investors to decide whether to hold, sell or buy shares in any of the 2000 companies listed on the Australian Securities Exchange, or become involved in other sharemarket investments.

Furthermore, in a sharemarket chart, the amount of shares sold and the highest and lowest prices for such shares may be included. This information is relevant for most investors, economists and advisers because it helps them in their sharemarket analysis.

## 3.6.2 Show me

### How to read a sharemarket chart

#### Procedure:

##### Step 1: Recognising the type of sharemarket chart

Look carefully at the chart heading and the headings of the columns to know what it is showing.

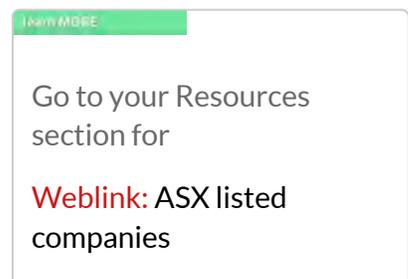
- Some charts divide listed companies into indices according to types such as industrial, metals and mining, energy and so on. This allows people to compare the financial performance of one company against other companies in the same sector by displaying the figures in one index.
- Other charts show the performance of the top 20, 50, 100, 200 or 300 listed companies, giving a more accurate general picture of the way the sharemarket is moving.
- For an overall picture of worldwide share price movements, other charts indicate the general picture in stock exchanges in the United States, Japan and elsewhere around the world.

##### Step 2: Learning the meaning of column headings

- Use an economics dictionary, glossary or the key (which accompanies the chart) to find out what each column is showing.

##### Step 3: Looking at the data

- Each listed company has a unique three-letter symbol, for ease of location in online charts or in daily newspapers. (Use the **ASX listed companies** weblink in your Resources section to see the companies listed on the Australian Securities Exchange.)
- Use a ruler to help you read accurately across the columns.
- + in front of a 'Move' number means that the value of a share rose against the previous day's closing value.
- – indicates that the share value fell against the previous day's closing value.
- Online links allow people to find recent and past financial information about any listed company, using tables and interactive charts.



##### Step 4: Analysing the data

- Examine the size of changes in data for a share from one period to another.
- Look for trends in the movement of shares in general or of particular shares.
- Compare shares to see how well or poorly one has performed against others.

- Use graphs and online interactive data to further analyse and compare data.

### Step 5: Making predictions

- Consider whether a trend will continue, change pace or change direction.
- Apply your knowledge of current economic events to judge their likely effects on particular shares.

### 3.6.3 Let me do it

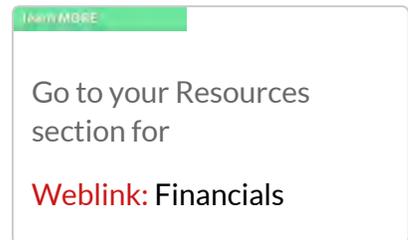
#### Developing my skills in reading a sharemarket chart

Indexes, such as the Banks index, enable comparison between the financial indicators for similar companies (in this case, banks). Go to the **Financials** weblink in your Resources section to view another sharemarket chart. You will see that this chart has a different layout from the chart in figure 1. The order of columns and some column headings have changed. Note that market cap is an abbreviation of *market capitalisation*. It refers to the value (capitalisation) the market puts on a company (obtained by multiplying the number of shares by the price per share).

#### Questions

Use the **Financials** weblink in your Resources section to answer the following questions.

1. Which bank's share recorded the highest price when last traded that day? (Use the code.)
2. How does this bank's share price compare with its highest price within the last year?
3. Which bank had the highest market capitalisation value for the day?
4. Which company recorded the greatest range between highest and lowest sales price for its shares over the last year?
5. How many of the codes do you recognise? Click on the codes of five of the banks and follow the links to find their full names.
6. Explain why a 'Move' figure of zero does not mean that the price of the share did not change during the day.
7. Compare the number of rises and falls and identify whether, overall, bank shares rose or fell on the day.
8. Select three bank shares that appear worth investing in. Justify your selection.
9. Explain why figures for one day are not necessarily a good basis on which to buy or sell shares.
10. Using the code for one of the banks whose shares you would consider buying, download or copy a graph showing its share price movements over a longer period, and explain how this might affect your initial decision.



## 3.7 Review

### 3.7.1 Summary

Making financial decisions has both risks and rewards. The risks involved in managing your money and making investments can be minimised by smart and sensible decision making. You need to be aware of the different options available to you in both types of financial institution and financial product. Investments such as property, term deposits, shares and managed funds are all options to increase your return and offer different rewards and risks. Insurance, savings and superannuation are important ways to plan for your future and achieve your financial goals.

- There are many types of financial institution in Australia including banks, credit unions and building societies.
- There are different types of investment you can make to increase your money, but all have different levels of risk.
- It is important to be aware and cautious of financial risks such as scams and identity theft.
- Debt can be good or bad debt, but always needs to be managed wisely.
- Insurance, savings and superannuation all help you protect yourself from financial risk and plan for the future.

### 3.7.2 Your turn

Lucky you! You have just inherited \$10 000 from an aunt living overseas that you did not even know existed. The lawyer contacting you tells your family that the aunt left no other beneficiaries. He directs you to a news article reporting her passing.

One week after finding out about your aunt, you receive a letter from the lawyer's firm in the mail. It tells you that the inheritance will be difficult to access because of government regulations. All you need to do is to provide your personal details, including credit card information, and a small amount of money to release the inheritance.

1. List some of the options available to you for investing the money you have inherited.
2. What financial risks are associated with these options?
3. Explain the action that should be taken with the inheritance letter.
4. Use the **SCAM watch** weblink in your Resources section to find out what you should do in response to the news of your inheritance. Write down some of the tips for protecting yourself.



Learn MORE

Go to your Resources section for

**Weblink:** SCAM watch