Risk Free Investments?

What comes to your mind if someone were to offer you a risk-free investment? Sounds too good to be true, isn't it? Seriously, is there such thing as totally risk-free in this world? One thing I know for sure is that there is no free lunch in this world and I am not talking about charity here.

First of all, what is considered a risk-free investment anyway? Technically speaking, it can be a security or a financial instrument which cannot default, and therefore, offers its investors a risk-free rate of return on their investment of capital. According to **Investopedia**, the risk-free rate of return is 'the theoretical rate of return of an investment with zero risk'. It further clarifies it as 'the interest an investor would expect from an absolutely risk-free investment over a specified period of time'. As a rough gauge of what constitutes risk-free investments, let's say if you are a legal working citizen in Malaysia or Singapore. In my opinion, one can consider our monthly statutory contributions of our salary to the EPF (Employee Provident Fund) as one of the safest forms of investments. We presume that the Governments will not default and the respective government agencies will do a good job in managing our hard-earned savings. Most importantly, take the EPF for instance; it has not failed in its annual dividend payouts over the years.

In fact, Malaysians have been receiving an annual payout of between 5% and 6% every year for the last 4 years, i.e. 2009 to 2012.Despite the declining rates in the last three decades, falling to as low as 4.25% p.a. in 2002, from the highest of 8.5% p.a. from1983 to 1987, Malaysian EPF contributors can expect to receive no less than the guarantee rate of return of 2.5% from their statutory contributions every year.

Now, we know that **"cannot be defaulted"** and/or **"guaranteed",** are two widely accepted words in defining a risk-free investment (theoretically) or serve as a good rule of thumb for investors looking for zero-risk investment. Having said that, we can generally take a 10- to 30- year government bond or Treasury bill as a risk-free instrument, assuming the government does not default on them. Given the fact that Governments do play an important key roles in the world economy, especially during the financial crisis where, through the central bank, it acts as the lender of the last resort. In the West, we have seen the U.S. Government various bailouts and interventions measures taken during the subprime crisis which started in the US in 2006 and subsequently spilt over to the world economy. In Malaysia, the government offered for the first time, a series of economic stimulus packages intended to save the economy from deepening from the economic recession in 2008 and 2009 as a result of the subprime crisis.

[Note: A country's domestic debt issued in the country's currency, is often considered risk-free as the country's country will always be able to pay the interest and principal, even if the Government has to print money to do it. Think about it, how do you default if you owe others money in your own currency? A country's debt denominated in foreign currencies is hence considered more risky than domestic debt]

On the other hand, in the current low interest rate environment in Malaysia, for instance, with interest rates averaging to 3% p.a.(source: Bank Negara Malaysia, BNM), prices of bonds will be relatively high. If you invest in the 10- to 30- year government bonds, MGS (Malaysian Government Securities) or any fixed income instrument, which give you an interest rate of between 3%p.a. and 5% p.a., your investment rate of returns (ROR) will be subjected to inflation risk. Now the general inflation rate in Malaysia is 1.6% (as of April, 2013, source: BNM), your real RORs (i.e. after netting off the inflation rate from the nominal interest rates of 3% to 5% p.a.) will be in the range of 1.4% p.a. to 3.4% p.a.

However, if you think it is safest to put your money in the bank in the long run as a fixed deposit (FD), which also gives you an interest rate of approximately 3% p.a., your real ROR will only be a bit more than 1% p.a. because more than half of your nominal ROR (i.e. interest of 3%p.a.) will be eaten away by inflation and your purchasing power will not grow as fast or even be eroded over the years.

There are two well-known and widely available inflation-fighters that had become increasingly popular with investors: namely, **REITS (Real Estate Investment Trusts)** – while unlikely to be totally fool-proof in fighting inflation, in the long run it should give some defense against the erosion of purchasing power and even provide a certain amount of return above inflation, and TIPS (**Treasury Inflation-Protected Securities)** – which are U.S. government bonds first issued in 1997, that automatically go up in value when inflation rises. The latter was said to be safe from risk of default because of the full faith and credit of the United States stands behind them and they guarantee that the value of your investment would not be eroded by inflation.

In addition, please ensure that you open a new account in another bank for every RM250K you wish to put your money in a bank. In Malaysia, this is the maximum amount per account in a bank protected and insured by PIDM, the deposit insurance system administrator in country. In Singapore, the SDIC (Singapore Deposit Insurance Corporation) plays a similar role and the insured amount is up to S$50K with a deposit insurance scheme member bank or finance company. **The question is if the bank offers a safe haven for your money, why is there a need for deposit insurance?**

Recently, I came upon a report from an overseas newspaper, which confirmed my concern over the escalating national debt that the country was facing alongside with other countries in Asia. The news report also highlighted the imminent debt issue that the emerging Asian economies are facing as follows:

"Debt Dilemma: Emerging Asian economies have been massing debt faster than their GDPs are growing, in stark contrast to the scaling back of private debt in the U.S. and Europe. Some economists are concerned that Asia's borrowing could eventually trigger a crisis."* ~ *THE WALL STREET JOURNAL, May 27, 2013.

Historically, debt was incurred by a nation during the state of national emergency or foreign threat like war and to finance the recovery of the aftermath of war. It should be pared down to zero in ordinary or good times. In the West, we should have learnt our lesson well from the recent European sovereign-debt crisis that hit Greece. **Greece is bankrupt**. So, if you think the sovereignty cannot be challenged, think again. Therefore, I strongly recommend you to read this book called **"Planet Ponzi",** authored by a hedge fund manager and Investor, Mitch Feierstein, and learn about how a vast overhang of national debt could do to you and financially burden our next generation. This book provides a provocative assessment on what politicians and policymakers have done to the financial industry and economy, and gives some advice on how we can save ourselves and families from the next financial meltdown.

This book also serves as a good guide for investor to identify what make up a sound and asset-rich government like Sweden. In essence, that is not to say that all risk-free investments cannot come from a government source as Feierstein suggests that investing in a shorter term government bond is still a good bet as the government is unlikely to default anytime today.

Risk Free Investments?

In making an investment, the higher your expected returns, the higher the risk you will have to take. The two variables are positively related. There is **no absolute free risk** in this world as even the safest investment carries a small amount of risk. Hence, we would normally consider the safest investment as risk-free from institution or organization which has the least likelihood to default. Even then, the extent of free risk of the so-called zero-risk instruments nowadays is very much dependent on the credibility and financial soundness of the issuers**.**

As an investor, we cannot avoid risks but we must learn to take calculated risks.

In **value investing,** I have learnt to be more prudent, even with my own investment portfolio which I have built over time, for good and to carry out research for every potential good growth company that I come across. This is because I realized **that capital preservation** is the first and foremost thing one needs to do to protect one's capital before we move on to **wealth accumulation**.

As **Benjamin Graham** defined investing, "**an investment operation is one which, upon thorough analysis, promises safety of principal and an adequate return.**

(Source: Millionaire Investors' Club)