Financial Wellness
& Education

Understanding investment risk

Your personal risk tolerance

Each person's comfort level with the risks associated with investing is unique. What may be a perfectly acceptable investment for you may give your neighbor sleepless nights. When creating your investment strategy, you will want to choose a portfolio that you are comfortable with, one that carefully balances risk and reward.

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Risk/reward tradeoff

It's a generally accepted concept that the greater the risk of an investment, the greater the potential reward. When comparing the performance of asset classes, the return of stocks has outpaced the returns generated from bonds and cash equivalents such as Treasury bills, over the long term.* It follows logically that the short-term returns of stocks tend to be more volatile than those of bonds and cash. It's true that with conservative investments like certificates of deposit (CDs) and U.S. Treasury bills you are guaranteed to get your investment back, but their returns may not keep pace with inflation. Conversely, higher risk investments, like stock in a start-up company, could produce spectacular returns. The downside? The company may fail and you would lose your investment.

Elements of investment risk

Before investing in certain products, it's important to understand the various risks that are associated with them. There are many different types of risk that an investment can be exposed to. They may include:

Market risk—Political, economic, geographic and other forces can influence the financial markets and affect the return of some assets. The general market environment, such as periods of bull and bear markets, may influence the performance of individual securities. Most investors are familiar with market risk, as the media gives a great deal of attention to the performance of the stock market. It's important to remember that this risk may affect virtually every asset class, including bonds and tangible assets such as real estate and precious metals.

Small- and mid-cap risk—Mutual funds that invest in the stocks of small- and/or medium-size companies are subject to "small- and mid-cap" risk. In general, the stocks of these companies are more volatile, and experience sharper price fluctuations than those of larger companies. This is because these companies generally have limited markets and financial resources, they are dependent on a smaller number of products and services, their earnings are less predictable and their management team may be small and inexperienced.

Foreign securities risk—Investing in foreign securities entails a number of special risks. For example, fluctuations in the currency exchange rate between the U.S. dollar and foreign currencies could have a negative impact on foreign securities. In addition, foreign securities are susceptible to political and economic instability, differing accounting and financial reporting standards and less stringent regulation of foreign financial markets.

Interest rate risk—All bonds are affected by changes in interest rates. When interest rates rise, the prices of bonds decline, and when interest rates decline, the prices of bonds rise. In general, the longer the maturity of a bond, the more sensitive it is to changes in interest rates. In general, longer-term bonds are issued with higher interest rates to compensate investors for the higher risk.

Default or credit risk—The financial strength of the issuer of securities may impact the value of an investment asset. If the issuer of a corporate bond experiences financial difficulties, it may not

* Source: CNN Money

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be able to make interest payments or repay principal and therefore it may default. In contrast, debt securities issued by the U.S. Treasury are not subject to default risk, as they are backed by the full faith, credit and taxing power of the federal government. Bonds with higher credit risk pay higher rates of interest to compensate investors for the greater chance of default. Bonds with greater credit risk are generally less sensitive to changes in interest rates, as their higher interest rates act as a sort of "shock absorber."

Liquidity risk—The possibility of not being able to sell an asset when you want to adds an element of risk to an investment. Generally, savings accounts, money market funds and other assets that can be quickly converted into cash are considered highly liquid. On the other hand, real estate, IRAs and deferred annuities are less liquid, as they may not readily be withdrawn from or sold.

Event risk—Mergers, acquisitions and other major occurrences can significantly affect a specific investment asset. For example, when one firm announces its intention to acquire another, the share price of both companies is affected. This risk applies to bonds as well, but is not a consideration for other assets such as savings accounts.

Inflation risk—The rise in the general level of prices decreases purchasing power and can erode the total value of your assets. Assets that are most susceptible to this risk include fixed income assets such as corporate and municipal bonds, and cash assets such as savings accounts and CDs. The value of some assets, such as real estate and common stock, tend to move parallel to the general price trend. Stocks have been considered an effective hedge against inflation because they have, over longer periods of time, outpaced the rate of inflation.

Tax risk—Taxation can erode the value of virtually every investment asset. Income and appreciation on assets will generally be subject to some form of taxation. It may be local, state, federal, estate or other type of tax, or a combination of several. However, some investments do have certain tax advantages. U.S. Treasury securities are exempt from state and local tax, and municipal bonds are free from federal income tax, and in certain cases, state and local tax as well. Other financial products such as IRAs, 401(k)s, annuities and life insurance have specific tax advantages as well.

Strategies to manage risk

Unfortunately, there's no such thing as a risk-free investment. Risk can never be completely eliminated. However, there are several strategies that may help manage investment risk.

Diversification—Because each asset class, and each specific asset, has its own unique degree of risk, it may be best to diversify money across a range of investments. An appropriate mix of aggressive, moderate and conservative investments could help balance the overall risk of your portfolio.

Asset allocation—Before choosing individual investments, it may be a good idea to determine how much money should be allocated to each asset class—cash, bonds and stocks. Asset allocation can help reduce short-term volatility while maintaining the potential to achieve long-term financial goals.

Professional management—Many investors have turned to professionally managed products such as mutual funds, variable annuities and variable life insurance. Along with offering diversification, each portfolio is closely monitored by a professional manager who makes investment decisions based on careful analysis and thorough research. Of course, like any investment, these financial products involve risks and you can lose money by investing. You should read the prospectus carefully before you invest or send money.

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