# Defining Risks in Investing

THE RETIREMENT GROUP LLC

PARTNERS IN RETIREMENT

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# Introduction

Risk is one of the most commonly used terms in finance and investing. Despite how often it is discussed as a factor to be considered when making investment decisions, few terms are more imprecisely defined. Frequently, when people are discussing risk they are talking about investment risk, or the historical price volatility of the asset or investment in question.

Investments that are generally classified as “risky” are those that have experienced extreme changes in prices in the past. An investment that has been historically volatile is expected to continue to be so. The presumed unpredictability of the investment’s future performance is perceived as risk, therefore assets with prices that have had a narrower range of peaks and valleys are considered less risky.

While price volatility can create uncertainty, it is important to consider that short term volatility can actually create buying opportunities by creating a gap between price and value of the investment. Therefore, it is an imperfect definition of risk. On a more intuitive level, we consider risk as the chance that the investment will provide lower returns than expected, or more important to consider, the chance that there will be a permanent loss of capital. Because every investment carries risk (including the possible loss of capital), it is important to understand the different kinds of risk and how much risk you can and/or should take on.

# Why volatility is considered risky

Volatility is generally the most common measure of risk used in investing, but why? Take an investment of $100,000 each in a stable investment returning and a more volatile investment, both averaging annual returns of 10%, and hold for 20 years. For purposes of this example, the stable investment returns 10% each and every year and the more volatile investment alternates between returns of 5% and 15%. It would seem obvious that investments that average the identical annual returns would finish with the same values. However, when you account for compounding, you find that the stable investment finishes with a CAGR of 10% but the volatile investment finishes with a CAGR of 8.7%. No investment is perfectly stable, but this example illustrates that larger swings in prices can cause a larger drag on returns.

Past performance is not a guarantee of future results, but generally the negative effect of short-term price volatility can reduced with longer holding periods. On this point, using short term funds to invest in volatile assets can add additional risk of being forced to sell to raise cash when investment is at a loss.

# Other types of risk to consider

Volatility is the most commonly referred to form of investing risk, but there are additional risks that need to be considered when making investment decisions:

- **Credit (Default) Risk**: The risk that bond issuer will not be able to meet principal or interest obligations to bondholders.
- **Currency Risk (for international investments)**: The possibility that fluctuation of exchange rates between U.S. and foreign currencies will negatively affect the value of foreign investment, as measured in U.S. dollars.
- **Inflation (purchasing power) risk**: The possibility that prices will rise in the economy as a whole, therefore decreasing your ability to purchase goods and services. For instance, if inflation is increasing at a rate above your rate of return on your investment, you will lose purchasing power with that asset.
- **Interest rate risk**: The possibility that an investment's value will change due to an increase or decrease on interest rates.
- **Liquidity risk**: The possibility that an investment cannot be converted to cash. Also refers to how easily an investment can be converted to cash without a significant loss of capital.
- **Market (systematic) risk**: The possibility of an investor experiencing losses due to factors (economic, political, etc.) that affect the overall performance of the financial markets.
- **Political risk**: The possibility that political changes or instability can have a negative impact on investment returns.
- **Reinvestment rate risk**: The possibility that proceeds from the payment of principal and interest will have to be reinvested at a lower rate than the original investment.

# The Risk/Reward Relationship

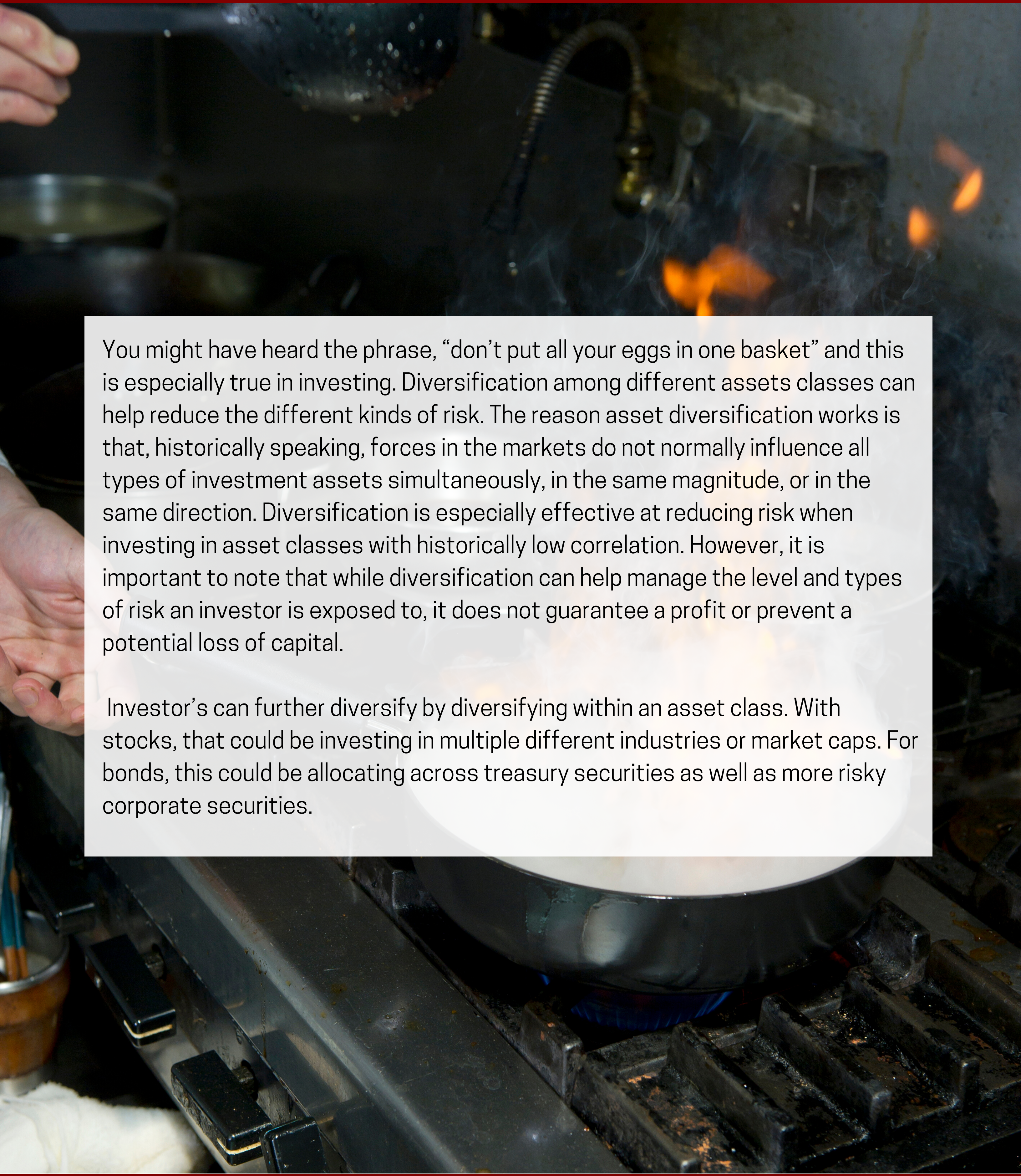
Generally, the more risk an investor takes on, the higher potential returns or losses will be. This should be intuitive to most people (except those with risk seeking behavior), that a person would not take on a greater potential for loss unless there was a potential for more return. Therefore, the goal should be maximizing returns while maintaining an appropriate and suitable level of risk.

When considering your own risk tolerance, there are two factors should be considered: the comfort level of the investor with potential losses and the financial ability of the investor to handle those potential losses.

The first factor is relative to the individual's personality. For example, if the investment is causing you to stay up at night or makes you consider selling at every dip, it may be too risky.

The second factor is influenced by amount of assets, age and phase in life, liquidity needs, and goals. For instance, a 35 year old investor may be able to take on more risk than someone who is two years from retirement as they have more time to overcome the loss or until they need to start making withdrawals.

# How Diversification reduces "Risk"



You might have heard the phrase, “don’t put all your eggs in one basket” and this is especially true in investing. Diversification among different assets classes can help reduce the different kinds of risk. The reason asset diversification works is that, historically speaking, forces in the markets do not normally influence all types of investment assets simultaneously, in the same magnitude, or in the same direction. Diversification is especially effective at reducing risk when investing in asset classes with historically low correlation. However, it is important to note that while diversification can help manage the level and types of risk an investor is exposed to, it does not guarantee a profit or prevent a potential loss of capital.

Investor’s can further diversify by diversifying within an asset class. With stocks, that could be investing in multiple different industries or market caps. For bonds, this could be allocating across treasury securities as well as more risky corporate securities.

# Conclusion

When you invest, you make choices with what to do with your financial assets. Risk is an uncertainty with respect to your investments that has the potential to negatively affect a person's financial welfare. An investor should be aware of and understand all risks before making an investment, and if appropriate, should consider the impact of a new investment on the current portfolio. Some ways you can understand how much risk is appropriate for you is to understand your current financial situation, plan what your future goals will be and what you will need to do to get there.

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