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# Understanding Investment Risk

Risk is often reduced to market volatility, or more simply, the chance to lose money. In reality, risk investing refers to the possibility that your returns may fall short of expectations or that you could lose some or all of your investment.

No investment is entirely safe, not even those considered conservative. Because of this inherent risk, it is essential to understand the different types of risk in personal finance, how to manage them effectively, and how your own comfort level with risk can guide your investment decisions.

## Risk Types

There are many forms of risk to consider when investing. Here are some examples:

- **Currency risk** refers to the possibility that fluctuations in exchange rates between U.S. and foreign currencies could reduce the value of an international investment when measured in U.S. dollars.
- **Default risk**, also known as credit risk, is the possibility that a bond issuer may fail to make interest payments or repay the principal to bondholders.
- **Inflation risk**, also known as purchasing power risk, refers to the chance that rising prices across the economy will reduce your ability to buy goods and services. For example, even if your investment earns a 6 percent return, a surge in inflation to double digits could mean that the money you receive has less buying power than it does today. This risk is often overlooked by fixed income investors who avoid the volatility of the stock market entirely by keeping money only in cash and savings accounts.

- **Interest rate risk** refers to how changes in prevailing interest rates can impact the value of certain investments, especially bonds. Typically, bond prices move in the opposite direction of interest ratesâ??when rates go up, bond prices tend to fall, and when rates go down, bond prices usually rise. But this isnâ??t always the case. If you need to sell a bond before it reaches maturity and interest rates have increased since your purchase, you may receive less than your original investment.
- **Liquidity risk** is the possibility that your investments may not be easily converted into cash. In some cases, it also means they might not be converted without a loss of your principal investment.
- **Market risk** involves the potential for an investment to decline in value due to widespread economic, political, or other systemic factors. These factors can affect entire markets, not just individual assets.
- **Political risk** involves the potential impact of government actionsâ??such as new laws, policy shifts, or changes in foreign leadershipâ??on financial markets, industries, or individual companies. These developments can disrupt investment performance both in the U.S. and globally.
- **Reinvestment rate risk** is the chance that future reinvestments may earn a lower return than the original investment. For instance, a five-year bond yielding 3.75 percent might mature at a time when similar new bonds offer only a 3 percent yield, reducing your overall earnings potential.
- **Volatility risk** refers to the unpredictable changes in the value of individual stocks or the broader market. Investments with lower price swings tend to be more appropriate for short-term goals, while those with higher volatility may be better suited for long-term strategies where thereâ??s more time to recover from dips.

### Balancing Risk and Potential Return

In most cases, risk and reward are directly correlated. Typically, this means the more risk you take, the greater your chances of earning higher returns. On the other hand, there is also a greater chance that you will incur losses.

Most people understand this concept because it aligns with our instinct to avoid uncertainty. Still, the possibility of bigger gains often encourages investors to accept more risk. The key is finding the right balance. Your goal is to grow your investments without taking on more risk than is appropriate for your situation.

### Risk Tolerance Versus Risk Capacity

What is traditionally described as *risk tolerance* can be broken into two concepts. First, risk tolerance is emotional, referring to your comfort level with uncertainty and market swings. If you are losing sleep over your investments, you may be taking on more risk than you can handle.

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*Risk capacity* is your ability to absorb losses based on your age, goals, and time horizon. A 35-year-old who is investing with a goal of retiring in 30 years has a higher risk capacity than a person who is already retired, simply because they have more time to recover from short-term losses and benefit from long-term growth.

**Managing Risk with a Diversified Portfolio**

Diversification helps reduce risk by spreading investments across different asset classes and types. Since markets donâ??t move in sync, gains in one area can offset losses in another.

Diversification does not guarantee profits or prevent losses, but it helps manage risk. A classic portfolio mix is 60 percent stocks and 40 percent bonds, designed to balance growth and stability. But even that approach has limits, like in 2022, when both stocks and bonds declined.

You can also diversify within an asset class. Large-cap stocks behave differently than small-cap stocks. Bond investors can spread risk across treasuries, corporate bonds, and municipal bonds. This helps reduce the impact of any single investment on your overall portfolio.

**Key Sources for Investment Information**

Before making any investment decisions, itâ??s important to fully understand the product in which you are investing. Begin by referencing reliable information sourcesâ??such as a mutual fundâ??s prospectus, which outlines its goals, fees, risks, and expenses.

Third-party financial publications and websites can also provide valuable information. They offer credit ratings, news, and performance comparisons. For mutual funds, these sources often provide ratings and analysis that help you evaluate how a fund stacks up against its peers. The Securities and Exchange Commission (SEC) is another reliable resource for company filings and disclosures.

Talking to a financial advisor can be a valuable step. They can clarify how specific investments align with your overall financial goals and ensure your strategy reflects your personal risk tolerance.

*Resource by the CAPTRUST wealth planning team*

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