Understanding Investment Risk

In personal finance, few terms are as important—or as ubiquitous—as the word risk. Yet few terms are also as imprecise. Typically, when financial advisors or pundits talk about investment risk, their focus is on the historical price volatility of an asset or investment.

What is the definition of risk? Generally, risk refers to the overall likelihood that your investment will provide lower returns than expected or that you may lose the entire investment. It's important to remember that every investment, whether labeled as risky or conversative, still carries some degree of risk, including the possible loss of principal. There is no guarantee that any investment strategy will be successful. That's why it makes sense to understand the kinds of risks that exist in personal finance, how to manage them, and how your individual risk tolerance can inform your investment strategy.

Types of Risk

Here are a few of the many different types of risk:

- *Volatility risk*. This refers to unpredictable price swings in the value of a stock or in the market at large. Lower-volatility investments are generally more suitable for short-term investments, while higher-volatility investments are better suited for longer-term investment horizons.
- *Market risk*. This term refers to the possibility that an investment will lose value because of a general decline in financial markets due to one or more economic, political, or other factors.
- *Inflation risk*. Sometimes known as *purchasing power risk*, this term refers to the possibility that prices will rise in the economy as a whole, so your ability to purchase goods and services would decline. For instance, your investment might yield a 6 percent return, but if the inflation rate

rises to double digits, the invested dollars that you got back would buy less than the same dollars today. Inflation risk is often overlooked by fixed income investors who shun the volatility of the stock market completely.

- *Interest rate risk*. This term relates to increases or decreases in prevailing interest rates and the resulting price fluctuation of an investment, particularly bonds. There is an inverse relationship between bond prices and interest rates. In other words, as interest rates rise, the price of bonds generally falls. And as interest rates fall, bond prices tend to rise. If you need to sell a bond before it matures and interest rates are higher than when you purchased the bond, you run the risk of losing some of your principal.
- *Reinvestment rate risk*. This term refers to the possibility that funds might have to be reinvested at a lower rate of return than that offered by the original investment. For example, a five-year bond with a 3.75 percent yield might mature at a time when an equivalent new bond pays only 3 percent.
- *Default risk*. Also called *credit risk*, this term refers to the risk that a bond issuer will not be able to pay its bondholders interest or repay principal.
- *Liquidity risk*. This term refers to how easily your investments can be converted to cash. Occasionally, this term may also refer to how easily your investments can be converted to cash without loss of principal.
- *Political risk*. This term refers to the possibility that new legislation, policy changes, or changes in foreign governments will adversely affect the U.S. or global capital markets, specific industries, or specific companies you invest in.
- *Currency risk*. For those making international investments, this term refers to the possibility that the fluctuating rates of exchange between U.S. and foreign currencies will negatively affect the value of a foreign investment, as measured in U.S. dollars.

The Relationship between Risk and Reward

In general, the more risk you're willing to take on, the higher your potential returns and your potential losses. This idea is probably familiar and makes sense to most of us. People are wired to avoid risk. Yet the potential for higher investment returns often becomes incentive to make a higher-risk investment. That is the trade-off. As an investor, your goal is to maximize your returns without taking on an inappropriate level or type of risk.

Understanding Your Own Tolerance for Risk

The concept of risk tolerance is twofold. First, it refers to your personal desire to assume risk and your comfort level with doing so. In this sense, your risk tolerance is relative to your personality and feelings about taking chances. If you find that you can't sleep at night because you're worrying about your investments, you may have assumed too much risk.

Second, your risk tolerance is affected by your financial ability to cope with the possibility of loss, which is influenced by your age, your stage in life, how soon you'll need the money, your investment objectives, and your financial goals. If you're investing for retirement and you're 35 years old, you may be able to endure more risk than someone who is 10 years into retirement because you have a longer time frame before you will need the money. With 30 years to build a nest egg, your investments have more time to ride out short-term fluctuations in the hope of greater long-term rewards.

Reducing Risk through Diversification

You may have heard this old saying: “Don’t put all your eggs in one basket.” This adage applies to investments as well. Specifically, you can potentially offset the risk of any one investment by spreading your money across several asset classes. Diversification strategies take advantage of the fact that market forces do not normally influence all types or classes of investment assets at the same time or in the same way, although there are often short-term exceptions.

Swings in overall portfolio return can potentially be moderated by diversifying your investments among assets that are not highly correlated—that is, assets whose values may behave very differently from one another. In a slowing economy, for example, stock prices might be going down or sideways, but if interest rates are falling at the same time, the price of bonds would likely rise.

Diversification cannot guarantee a profit or ensure against a potential loss, but it can help you manage the level and types of risk you face. The traditional diversified portfolio, for instance, is 60 percent stocks and 40 percent bonds. This portfolio aims to take advantage of the low correlation between stock and bond markets. Yet in 2022, stock values and bond values both declined. This unusual occurrence is a recent example of the limitations of diversification.

In addition to diversifying among asset classes, you can also diversify within an asset class. For example, the stocks of large, well-established companies may behave somewhat differently from stocks of small companies that are growing rapidly but may be more volatile. A bond investor can diversify among Treasury securities, more risky corporate securities, and municipal bonds, to name a few. Diversifying within an asset class helps reduce the impact on your portfolio of any one stock, bond, or mutual fund.

Evaluating Risk: Where to Find Information about Investments

Before making an investment decision, aim to become fully informed about each investment product. There are numerous sources of information that can be helpful in your search. Some of this information will come from the company that is offering the investment—for instance, the prospectus of a mutual fund.

You can also find helpful information in third-party business and financial publications and websites as well as annual and other periodic financial reports. The Securities and Exchange Commission also can supply information.

Third-party business and financial publications can provide credit ratings, news stories, and financial information about a company. For mutual funds, third-party sources provide information such as ratings, financial analyses, and comparative performance relative to peers. Note: Before investing in a mutual fund, carefully consider its investment objectives, risks, fees, and expenses, which can be found in the prospectus available from the fund. Read it and consider it carefully before investing.

Speaking with a financial advisor can also be a good idea. Advisors can provide helpful perspective on individual investments and asset classes and can help you understand how your personal risk tolerance can impact your financial plan and your financial goals.

Source: Broadridge Investor Communication Solutions, Inc.