Risk and Return

Risk is something you encounter every day. Even crossing a busy street involves some risk. With investments, balancing risk and return can be a tricky operation. All investors want to maximize their return, while minimizing risk. Let’s face it, putting your hard earned dollars on the line can be downright frightening.

Some investments are certainly more “risky” than others, but no investment is risk free. Trying to avoid risk by not investing at all can be the riskiest move of all. That would be like standing at the curb, never setting foot into the street. You’ll never be able to get to your destination if you don’t accept some risk.

In investing, just like when crossing that street, you carefully consider the situation, accept a comfortable level of risk, and proceed to where you’re going. Risk can never be eliminated, but it can be managed. Let’s take a look at the different types of risk, how different asset categories perform, and the ways and means to help manage risk.

Types of Risk

When most people think of “risk” they translate it as loss of principal. However, there are many kinds of risk. Let’s take a look at some of them:

- **Capital Risk** – Losing your invested monies.
- **Inflationary Risk -** Investment’s rate of return doesn’t keep pace with inflation rate.
- **Interest Rate Risk** - A drop in an investment’s interest rate.
- **Market Risk** - Selling an investment at an unfavorable price.
- **Liquidity Risk** - Limitations on the availability of funds for a specific period of time.
- **Legislative Risk** - Changes in tax laws may make certain investments less advantageous.
- **Default Risk** - The failure of the institution where an investment is made.

How Do Different Assets Perform?

It may seem that there are countless types of investment products to choose from but, basically, there are three types of core investments: cash (or cash equivalents), bonds, and stocks.

Cash

Investments such as bank savings and checking accounts, Certificates of Deposit (CDs), and Treasury Bills. The prices generally don't fluctuate very much. To investors concerned with loss of capital risk, cash would appear to be the most secure choice, as principal is guaranteed and/or insured. Savings and checking accounts are highly liquid, as they can be readily converted into cash. With CDs, you may face liquidity risk, as they must be held for a predetermined period of time or may be subject to penalties for premature withdrawal. Although risk to principal may be minimal, loss of purchasing power, or inflationary risk, must be taken into consideration. When inflation and taxation are taken into account, returns can be considerably lower.

Bonds

Commonly called "fixed income investments," bonds are basically loans or "IOUs." Interest is earned on the money you lend. The prices of bonds do move up and down, but normally not as much as stocks. Many people think of bonds as conservative investments, but the returns can have a high degree of volatility. The fluctuation of interest rates is called interest rate risk, and a downturn in the bond prices could significantly decrease the overall return of any particular bond.

Stocks

Represent equity in, or partial ownership of, a company. An easy way to remember the difference between stocks and bonds is: "With stocks, you own. With bonds, you loan." The price of a stock or share can move up or down, sometimes a lot. The returns of stocks from year to year can be quite volatile, but, historically the returns from stocks have significantly outpaced inflation, and topped the returns from cash and bonds as well.

Finding Your Comfort Zone

It's possible to achieve higher returns through stocks rather than bonds, and through bonds rather than through cash, but you can't expect to get higher returns without taking on some degree of unpredictability. If you seek higher returns, you have to be willing to live with higher risk. "How much risk is right for me?" The answer will affect your investment decisions. Although past performance is not a guarantee of what will happen in the future, historical results over a long period of time can help you make your investment decisions.

The Ways to Manage Risk

There are a number of strategies that can help limit risk while offering the potential of higher returns. However, keep in mind these strategies do not assure a profit nor protect against a loss in a declining market.

Diversification

Invest in a variety of investments, or simply following the old adage, "Don't put all your eggs in one basket." With a portfolio spread among several different investments, you benefit when each type is doing well, and also limit exposure when one or more investment is performing poorly.

Asset Allocation

Building upon the diversification concept, with asset allocation you create a customized portfolio consisting of several asset categories (cash, stocks, bonds) rather than individual securities. Changing economic conditions affect various types of assets differently; consequently, each asset category's return may partially offset the others'.

Dollar Cost Averaging

This is systematically investing a fixed dollar amount at regular time intervals. When this disciplined program is adhered to and market fluctuations are ignored, it attempts to "smooth out" the ups and downs of the market over the long haul. Dollar cost averaging does not assure a profit, nor does it protect against loss in a declining market; you must consider your ability to continue investing on a regular basis under all market conditions.

The Means to Manage Risk

Most investors find it difficult to diversify effectively across the full spectrum of cash and individual stocks and bonds. That is why, if suitable, many investors have chosen mutual funds and/or variable products to apply the strategies previously mentioned.

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