Module 7 Article

The Delicate Balance Of Risk-Reward

Risk Vs. Reward

Investing in riskier assets can be a beneficial strategy for those looking for higher returns, but it also comes with its own set of risks. Picking the right asset class is the first step to successful investing and understanding the long-run average rates of return is essential.

- **Small Company Stocks:** Small-company stocks have historically had higher levels of volatility and lower liquidity than larger companies, but they have also provided higher returns over the long run. A diversified portfolio of small-company stocks has a much higher potential for appreciation over time than large companies or corporate bonds as small companies tend to grow faster than larger ones. With that said, smaller stocks are inherently more risky, as their prices are prone to wild swings in either direction.

- **Large Company Stocks**: Large-company stocks often provide good returns, especially when held for long periods of time. Investing in large companies offers a degree of stability that cannot be found with smaller firms, as these businesses typically have more established management teams and broader product lines that help protect against economic recessions. While not as volatile as small-company stocks, large-company shares do carry some uncertainty due to unforeseen changes in market conditions or competitive pressures from other firms.

- **Corporate Bonds**: Corporate bonds are usually seen as a safer option than equities because they provide periodic fixed income streams plus the assurance that principal will be repaid at maturity (unless default occurs). Corporate bonds tend to pay slightly higher interest rates than government bonds but come with greater credit risk since there's no guarantee that principal or interest payments will always occur on schedule if the issuing company's finances change suddenly or unexpectedly.

- **Treasury Bonds**: Treasury bonds are regarded as one of the safest investments available due to their low default rate since the US government backs them up unconditionally through its promise to repay on time every month and year until maturity. Although Treasury bonds may not necessarily offer high yields compared with other fixed income instruments like corporate bonds or high yield ETFs they do offer a relatively safe store of value over long periods of time with very low volatility due to their guaranteed security by Uncle Sam himself - even during times of financial crisis or recessionary periods where stock markets may plunge hard .

Pros & Cons Of Mutual Funds Vs. Individual Stocks

Investing in a diversified mutual fund can provide investors with the benefit of having a wide variety of investments, with less risk than investing in individual stocks. A diversified mutual fund is one that holds a variety of stocks, bonds, and other assets in order to spread the risk among many different sectors and companies. This reduces the amount of risk an investor faces, as compared to investing in just a few individual stocks. Additionally, due to economies of scale, mutual funds are able to offer lower fees than that which would be charged for purchasing individual stocks. Mutual funds also provide investors with access to professional management, which ensures that the portfolio is managed by experts who understand the markets and take steps to protect their investments.

On the other hand, mutual funds tend to have higher expense ratios than those associated with investing in individual stocks. This means it can be more expensive for investors to buy into a mutual fund rather than individually purchasing shares of stock.

Secondly, it is important for investors to keep in mind that there is still some level of risk associated with investing in a diversified portfolio; while spreading investments out reduces overall risk, it does not completely eliminate it.

The expected rate of return on value stocks or mutual funds tends to be lower than growth stocks or mutual funds because value stocks have already been through some form of price appreciation at the time they are purchased and therefore do not offer investors much potential upside when they purchase them. In contrast, growth stocks are relatively undervalued at purchase time and therefore offer more potential upside when they appreciate over time.

So What If You Are Risk Averse?
For a very risk-averse person, an appropriate asset allocation would include a higher concentration of low-risk investments such as cash equivalents and government bonds. They should also incorporate some level of diversification in their portfolio by allocating moderate portions to stocks, real estate, commodities, and other asset classes. The overall composition should be heavily tilted towards fixed income investments with minimal risk exposure. A long-term goal should involve larger allocations to both lower and higher-risk assets such as domestic and international stocks, corporate bonds, REITs, and other alternative investments like gold or cryptocurrency. This mix can help achieve growth while ensuring that short-term fluctuations do not derail the overall plan.

For a very risk tolerant person on the other hand, they can afford to take on more risk given their greater appetite for losses in exchange for potential gains. Their portfolio should be composed of more volatile assets such as equities, global stocks and emerging markets bonds. The short-term goal here could look at a higher allocation to cash equivalents such as money market funds to provide liquidity while still allowing for some growth potential through small amounts of stock purchases along with other asset classes like real estate investment trusts (REITs) or commodities. For the long-term goals, keeping a balanced approach is important since it allows for more aggressive investing but also provides stability in volatile times by having allocations to different asset classes spread out over different markets worldwide.

STANDARDS: 4.12.3a, 4.12.3b, 4.12.3c, 4.12.3d, 4.12.6a, 4.12.6b, 4.12.6c, 4.12.6d