Types of Investment Risk

Whenever an individual takes cash and puts it to work in any form of investment, he or she does so with the anticipation of receiving a return on the money. At some future point in time, the investor expects to get back both the principal amount and something extra as well. The possibility that an investment will return less than expected is known as "investment risk."

Risk vs. Reward

One of the general truths of the investment world is that risk and reward go hand in hand. The greater the risk an investor is willing to undertake, the greater the potential reward. If an investor is willing to assume only a small amount of risk, the potential reward is also low. In an ideal world, there would be no risk to any investment. Unfortunately, such a risk-free investment does not exist.

There is also more than one type of risk. An investor must understand each type of risk, and use that knowledge to create a portfolio of investments that balances the level of risk assumed, with the desired investment return.

Market Risk

In simple terms, market risk can be defined as the possibility that downward changes in the market price of an investment will result in a loss of principal for an investor. For many, market risk is most closely associated with the ups and downs of the stock market.

Market risk exists for other investments as well. For example, the market price of bonds and other debt investments will move up and down in response to changes in the general level of interest rates. If interest rates rise, bond prices generally fall. If interest rates decline, bond prices generally rise. Tangible assets such as real estate and gold, or collectibles such as art or stamps, also face market risk.

Over time, a number of strategies have been developed to help reduce market risk.

- Invest only dollars that are not required to meet current needs. This helps avoid having to sell an asset when the market may be down.

- Develop a long-term approach. A longer time horizon allows an investor to ride out market ups and downs.
- Diversify your investments over a number of asset categories, such as stocks, bonds, or cash, and tangible investments such as real estate. Holding assets in different investment categories reduces the possibility that all investments will be down at the same time.

Inflation Risk

For many individuals, safety of principal is the primary goal when deciding where to place investment funds. Such investors frequently put much of their money in bank savings accounts, CDs or T-Bills. While such investments can provide protection from market risk, they do not provide much protection from inflation risk. An investor may hold the same number of dollars; over time, however, those dollars buy less and less.

For example, consider a hypothetical investor who places $10,000 in a 10-year certificate of deposit, earning 2.00% per year. The table below summarizes the effect of a 3.00% annual inflation rate on the purchasing power of these dollars.

End of Year	CD Value at End of Year[1] (2%)	Purchasing Power at 3% Inflation Rate[2]	"Real" Value of CD	"Loss" Due to Inflation
1	$10,200	97.09%	$9,903	$297
2	$10,404	94.26%	$9,807	$597
3	$10,612	91.51%	$9,712	$901
4	$10,824	88.85%	$9,617	$1,207
5	$11,041	86.26%	$9,524	$1,517
6	$11,262	83.75%	$9,431	$1,830
7	$11,487	81.31%	$9,340	$2,147
8	$11,717	78.94%	$9,249	$2,467
9	$11,951	76.64%	$9,159	$2,792
10	$12,190	74.41%	$9,070	$3,119

Values shown in this presentation are hypothetical and not a promise of future performance.

[1] Assumes a 2.0% annual after-tax return, and that interest is reinvested at the same rate of return.

[2] To calculate, divide previous year's percentage by (1+.03). Example: 1.00 / 1.03 = .9709; .9709 / 1.03 = .9426.

Over the 10-year period, inflation reduces the purchasing power of the investor's dollars by more than 25%. The impact of income taxes, ignored in this example, would further decrease the investor's net return.

While there are ways to potentially shield your portfolio from inflation risk, most involve a higher level of market risk:

- Consider placing a portion of your assets in the stock market.
- Historically, tangible assets such as real estate or gold have tended to do well in periods of high inflation.

Other Common Risk Types

In addition to market and inflation risk, there are a number of other common types of risk that each investor must be aware of:

- **Credit risk:** This is also known as "default risk." The chance that the issuer of a bond or other debt-type instrument will not be able to carry out its contractual obligations. Keeping maturities short, diversifying investments among various companies, and investing in institutions and issues of the highest credit rating are common methods used to help control this type of risk.
- **Liquidity risk:** This risk is the possibility that an investor will not be able to sell or liquidate an asset, without losing a part of the principal, because there is an imbalance between the number of buyers and sellers, or because an asset is not traded very often. Choosing investments traded on an active market, and limiting investments to funds not needed for current expenses are approaches used to help lessen this risk.
- **Interest rate risk:** This is defined as the risk that an increase in the general level of interest rates will cause the market value of existing investments to fall. Generally, this risk applies to bonds and other debt-type instruments, which move opposite to interest rates. As interest rates rise, bond prices tend to fall, and vice versa. One approach to reducing this risk is to stagger or ladder the maturities in the portfolio so that a portion of the portfolio matures periodically, rather than all at the same time. Holding a security until maturity, at which time it is redeemable at full value, is also useful.

- **Tax risk:** This refers to the possibility that a change in tax law, at either the federal, state or local level, will change the tax characteristics of an investment. After such a legislative change, an investment may no longer meet an individual's needs. In some cases, new legislation has included a grandfather clause allowing current investors to continue under the old rules. Making an investment because it's a good investment, rather than focusing on the tax benefits, is an excellent way to help reduce this risk.