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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.

Coping With Market Volatility

During periods of economic uncertainty, financial markets are often characterized by wide swings in market value. Such “market volatility,” with prices sharply rising and falling, is a reflection of changeable investor sentiment as well as more substantive economic or political events. Even during more stable times, financial markets will fluctuate, although price movements tend to be more moderate. By their very nature, financial markets rise and fall constantly, with an ever-present potential for gain or loss.

So, how does an individual cope with constant market volatility?

Avoid an Emotional Response

When markets fall sharply, some investors will panic, sell all or part of their holdings, and shift assets into what are seen as “safer” investments. Such emotion-based selling after a market decline simply turns paper losses into real ones and limits any possible gains should the markets recover. Some individuals will respond emotionally and buy when the markets are “hot” and values are rising. The end result is often an investor who buys high, sells low, and then wonders, “What happened?”

“Timing” the Market

Some investors attempt to “time” the markets, buying when the market is low and then selling when the market is high. The problem is that it’s never clear just when the market has reached a trough or a peak. In the classic Wall Street phrase, “No one rings a bell.” Market timing is a concept that, in theory at least, seems logical. In practice, however, no one has yet devised a system for consistently and accurately identifying market tops and bottoms.

Diversify Your Portfolio - Asset Allocation

Asset allocation is an investment strategy that seeks to reduce investment risk by spreading an investor’s portfolio over a number of different asset types. This approach takes advantage of the tendency of different asset types to move in different cycles, and thus smooth out the ups and downs of the entire portfolio. Stocks, bonds, and cash (or cash equivalents) are the investments normally used. Tangible assets, such as real estate or gold, may also be included.

Coping With Market Volatility

The asset allocation process normally begins with an analysis of the historical levels of risk and return for each asset type being considered.[1] These historical values are then used as a guide to structuring a portfolio that matches the investor's individual goals and overall risk tolerance level.

Regularly Review Your Investment Strategy

An investor's portfolio allocation should reflect factors such as the investment goal, timeframe, need for liquidity, risk tolerance, and income tax bracket. As time passes, and as market and economic conditions change, it is likely that an investor's goals, and the optimal portfolio mix to reach those goals, will also change. Adjusting the asset allocation, known as "rebalancing," is a regular part of good investment management, in both up and down markets.

Take a Long-Term View

Historically, the long-term trend in equity markets has been upward, although there have been periods when the markets declined.

An investor can more easily ride out periodic economic storms by clearly understanding his or her long-term investment goals and rebalancing the portfolio accordingly. Additionally, a portion of the portfolio can be placed in safer, more liquid assets, which can then be used to meet immediate cash needs. The balance of the portfolio remains invested for the long term.

Automatic Investing

Rather than making a single, lump-sum investment, some investors feel more comfortable investing an equal dollar amount at regular intervals. Also known as "dollar cost averaging," this strategy does not guarantee a profit, nor does it protect against losses in a declining market. It does have the advantage of buying more shares when the price is low and fewer shares when the price is higher.

Seek Professional Guidance

In both bull and bear markets, the guidance of trained financial professionals is strongly advised.

[1] Historical data, while useful as a general guide, cannot be considered an accurate indicator of future results. There is no guarantee that past performance is a predictor of future investment performance.

The Perfect Investment

Once an individual or family has reached the stage in life where there is enough income to easily pay the monthly bills, there is often a desire to put the excess monthly cash flow to work. For some, an inheritance, a large bonus, or a distribution from a qualified plan can provide an investable, lump sum of money. For most people, the key question is, "How do I put this money to work?" In a perfect world, the answer would be an investment that has certain, ideal characteristics:

- **High rate of return:** A total return high enough to out perform inflation and taxes, and still meet the investment goal.
- **Complete safety:** There would be no concern that any part of the investment could ever be lost.
- **Always liquid:** An investor would be able to redeem the investment, and receive cash, at any time of day or night, every day of the year without any penalty or loss of principal.
- **No income taxes:** There would never be any income taxes due on the investment's yield or growth. The investor keeps everything earned.
- **No skill or knowledge required:** No special skill or knowledge would be required to manage the investment. One could just forget about the investment and enjoy life.

The Real World

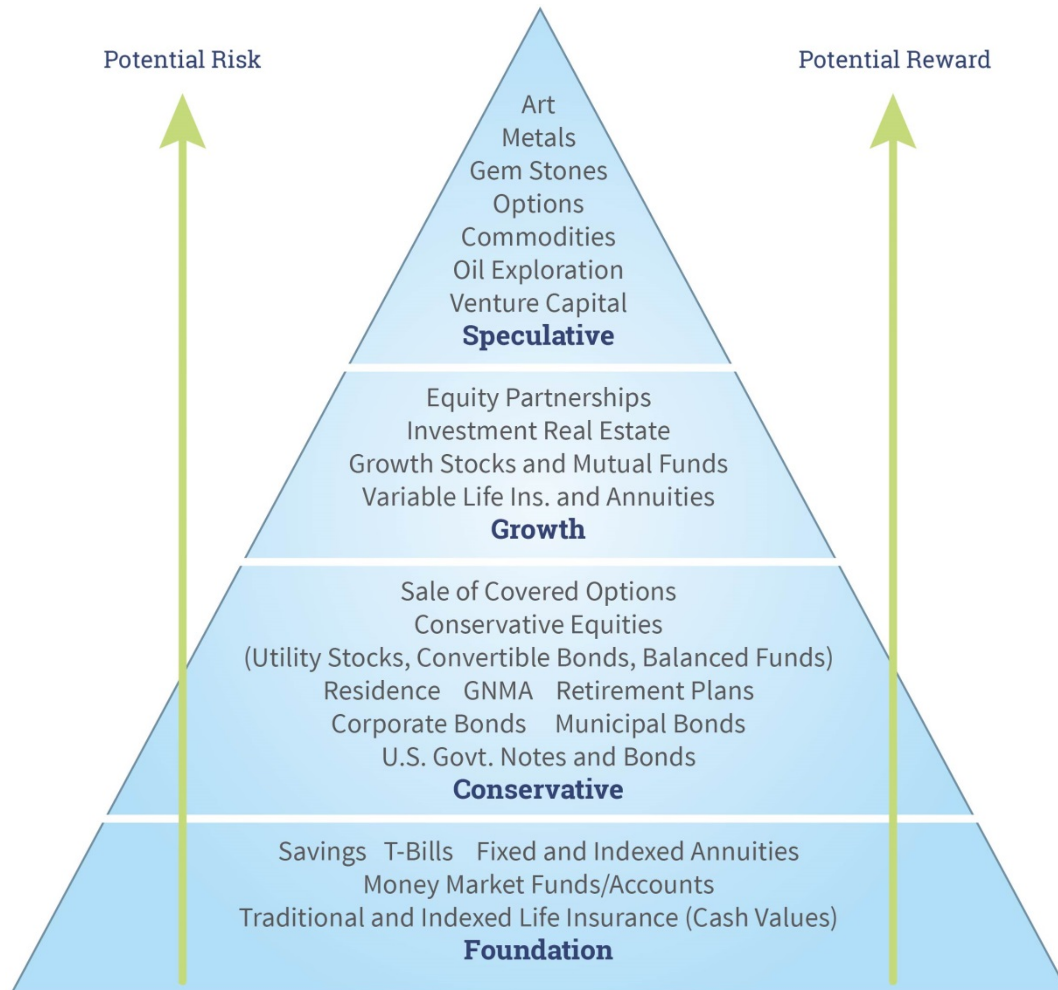
Such a "perfect" investment does not exist, of course. Most notably, investing involves risk, including the possible loss of all or a part of your principal. In the real world, individual investors must choose from a confusing range of investment tools, each with different characteristics and uses. The process of selecting the best investment for a particular need or situation is made easier by clearly answering the following questions:

- **Why are you investing?** Do you need income for current expenses or are you accumulating money for a future need?
- **When will the money be needed?** At any moment? A year from now? At retirement, 25 years from now?

- **How much risk are you willing to undertake?** Can you afford to lose all or a part of the investment, and not have the loss affect how you live?
- **Are income taxes a concern?** If the investment is currently taxable, to what extent will the additional tax reduce investment growth or push you into a higher tax bracket?
- **What is the economic outlook?** Investment opportunities will vary depending on whether the economy is growing or shrinking.
- **Do you have the skill and knowledge needed to manage your investment?** Is professional investment management needed?
- **How much money is there available to invest?** Are smaller amounts available periodically, or is there currently a larger, lump sum of money?

Pyramid of Investments

An investment program should be built like a pyramid - with a strong, broad base. As your potential reward increases so does the potential risk.



Note: This pyramid is intended solely to illustrate a concept; it is not a promise of investment performance. Investors may differ on the risk level to which a particular asset is assigned. Before making any investment in mutual funds, variable life insurance, or variable annuities, you should be sure to read the appropriate prospectus or offering documents for a complete discussion of the fees and risks involved.

Important Notice

This report is intended to serve as a basis for further discussion with your other professional advisors. Although great effort has been taken to provide accurate numbers and explanations, the information in this report should not be relied upon for preparing tax returns or making investment decisions.

Assumed rates of return are not in any way to be taken as guaranteed projections of actual returns from any recommended investment opportunity. The actual application of some of these concepts may be the practice of law and is the proper responsibility of your attorney.

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