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Understanding and Evaluating Risk

Whether we are cognizant of it or not, every day we face risk. Just walking down the stairs is risky as we could fall and sprain an ankle. Driving a car is risky as we could be in an accident that damages the car or causes injury to ourselves and our passengers. We understand though that risk is just a part of our daily lives and we do what we can to control it – we may choose not to drive on snowy days and we may choose not to store items on the stairs that we could trip over.

We also face risk when making investment decisions, although we may not always be aware of what that risk is. There are many different types of investment risk and every investment has some type of risk associated with it. The key to managing our investment risk is to understand our investment objectives, choose a risk level that is acceptable and that we can live with, and then monitor the investments on an on-going basis and make any necessary adjustments as the environment changes.

Did you know that purchasing a certificate of deposit (CD) has risk? One wouldn't think so as the value of the CD is generally guaranteed by the FDIC, which is essentially a form of insurance. So, what kind of risk could a guaranteed investment possibly have? The two predominate risks associated with CD's are inflation risk and liquidity risk. A CD possibly has inflation risk because while you will receive a positive return on your investment, after factoring inflation and particularly after factoring in inflation and income taxes, your net return could possibly be negative. Also, a CD is a somewhat illiquid investment because if you need access to the cash you could be subject to an early withdrawal penalty. So, yes, while there is little risk of loss of principal, there are other investment risks associated with a certificate of deposit investment.

At the other end of the investment spectrum, I think we are all aware of the market risk associated with stock investments. When our stock investment drops 40% in a short period of time just due to economic and market conditions we certainly are not going to be happy. But, clearly, that is a risk we take by investing in the stock market. Does that mean we choose not to invest in the stock market at all? For some folks, yes, it does mean they are choosing not to make that stock investment because they are not comfortable with the risk of loss of principal and that is okay because they have assessed the risk and made a conscience decision not to assume that risk.

However, there could also be a potential risk by not investing in the stock market for long term objectives. If the only investment owned was CD's, how much more money would need to be saved and invested in order to achieve a financial goal – say retirement? Since we know CD's have inflation risk and longer term they generally have a lower expected rate of return than stocks, we probably would need to save quite a bit more in order to achieve our objectives.

So, does it make sense to add a different type of risk to our portfolio by investing somewhat in stocks and somewhat in CD's and other things? Is it worth taking the risk and hedging our bets by assuming some market volatility risk and some inflation risk because we might be more likely to achieve our goal with some stock market exposure than with no stock market exposure?

I haven't discussed it here but bonds, international stocks, international bonds, currency, real estate, gold, commodities and other investments all have their own risks associated with them. The more we understand these different risks the better we can choose to manage our overall investment risk in a way that hopefully helps us achieve our financial goals and still allows us to sleep at night.