APPETITE FOR RISK

Investing is a risky business. Understanding the different types of investment risk and the impacts they play on returns is critical for planning a successful, long-term investment strategy.

Many prospective investors eventually shy away from a commitment when they hear the dreaded “R” word: risk. By itself, risk is innocuous, carrying no special meaning or predictive result. But the idea that investing one’s money is not foolproof; that there are risks involved, and that a return is speculative — the very idea is enough to burrow one’s savings into a secure bank account that earns a predictable interest rate (never mind that the figure is minuscule by any metric).

But not all risk is created equal. There’s “letting it all ride” on a long shot; and then there’s deliberate, calculated risk that is associated with sustained, long-term growth. Understanding the different types of risk is essential to evaluate whether an investment strategy aligns with your financial goals.

Risk and Return: A Closer Look
To keep it simple for now, let’s look at three main types of investments: stocks, bonds and cash investments.

Stocks typically carry the great level of market risk, and the highest potential for losing money in the short term. However, when looking at the long-term performance of the stock market, stocks have historically outperformed bonds and other cash investments. With this in mind, consider allocating assets that you intend to invest for 10-plus years into stock investments.

Bonds carry multiple risks: interest rate risk, which impacts a bond’s price; and credit risk, which applies to the bond issuer and the possibility of default. Interest rate changes impact bond prices more significantly than they do stock prices. When short-term rates increase, investors can therefore sell older bonds that carry a lower interest rate, which in turn leads to price reductions, favoring investing in newer bonds that pay higher rates. Overall, bonds have historically been more stable over the short-term than stocks.

Finally, **cash investments** such as 3-month **treasury bills** are typically less volatile than both stocks and bonds. However, they may not keep pace with inflation. For this reason, you may consider these cash investments for short-term situations, such as those when you intend to access your money within the year.

A Broader Context, a Clearer Understanding
With the above in mind, assess your investments — stocks, bonds and cash investments — in terms of a risk profile that aligns with your current and future goals. By investing in different types of assets, you minimize the collective risk of each while increasing your chances at reaping any potential benefits.

No investment portfolio will be risk-free, but taking these calculated risks can help you temper your losses.