INVESTING

Risk and Return

You may be wondering how money is made on the market. Without knowing when and why decisions are made, investing can seem like a high-stakes roll of the dice—especially after the 2008 financial crisis. But investing is not gambling, and understanding the concept of risk and return will help you make better sense of what truly influences your investments.

What is Return?

"Return" is simply the change in value since the start of an investment. If a stock or other asset goes up in price and sells for a profit, it has a positive return; if the asset sells for less than its purchase price, it has a negative return. Some returns do not involve actively trading assets. A savings account at a bank provides returns through its interest rates, while stocks and bonds can payout dividends without needing to be sold.

Returns are how people make money on the market; they are the incentive to participate in the global economy. The hope of growing money drives everything from home loans to mutual funds. However, while some might think of returns as "free money," there is always a risk of loss.

What is Risk?

Using the word "risk" to describe parts of the market can cause a misunderstanding of how things work. In common usage, the word "risk" describes a danger that someone voluntarily embraces. In terms of investment, risk has come to mean how much an asset's value fluctuates over time.

A risky stock is one that is difficult to predict; no one knows if it will rise or fall. The riskier the stock appears the less people are willing to pay for it. As the price falls, investors are able to buy more shares of the risky stock. The more shares they own, the greater their gains and losses when the stock price moves. A high level of risk creates a high potential for return.

Different types of assets have different levels of risk and return. In general, stocks have the highest risk and return of all assets. Most bonds are considered safer than stocks, but have much lower returns. Not surprisingly, cash equivalents, which have very little risk, provide meager returns.

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There is always some form of risk when investing money. Certain people try to avoid risk by putting their money into bank savings accounts or investing only in U.S. Treasury Bonds

FOUR FINANCIAL MANAGEMENT

(734) 272-4322
www.fourfinancial.com
900 Victors Way, Ste. 240
Ann Arbor, MI 48108

(considered a "riskless" asset). However, in both of these cases, people tend to lose money because inflation decreases value faster than marginal interest can make returns. Money put in the market may have some risk, but smart investing is preferable to the guaranteed loss of low-interest savings over a long period.

Diversification

With the rise of investment plans, the word "risk" has gained an expanded meaning for investor portfolios. Portfolio risk refers to the likelihood that a majority of assets will fail at the same time. For instance, a portfolio that invests in just one type of industry has high risk. The movements in that one part of the market affect the value of all the investor's assets.

"Diversification" is the planning method investors use to combat this kind of risk. Following the old saying, "don't put all your eggs in one basket," diversification attempts to secure a person's portfolio by investing in a variety of assets (stocks, bonds, cash equivalents, etc.) in a variety of different industries (technology, energy, manufacturing, etc.). While any one asset might fail, it is unlikely for several of them to drop all at the same time.

To improve on diversification, economists began to study correlations between asset movements. They determined that to achieve better diversification, investors should use assets that fluctuate independently from each other. This development quickly led to a model known as the "efficient frontier." This model demonstrates the ideal tradeoff between risk and return and gives financial advisors a benchmark for portfolio diversification.

Even though diversification can reduce portfolio risk by using unrelated assets, it cannot eliminate it. All investments are affected by their market. Dangers to the overall market are referred to as "systematic risk." If there is an economic crash, diversification disappears—every asset becomes tied to the collapse and they all drop. All investors need to accept that systematic risk can never be completely avoided.

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The Risk of Failure

With the development of mathematically sound investing, yet another use of the term "risk" came about. Since the vast majority of well-diversified portfolios make money if given enough time, the concern for modern investors is whether it will grow soon enough.

Whether it is a college fund or a retirement plan, investors need to set a goal for the returns they would like to see. High returns might lure investors to take on more risk, but the market never promises anything. Though a portfolio with risky assets is more likely to eventually provide a high return, but it is just as likely to bring short-term losses. The investor's ability (or need) to accept this volatility is known as "risk tolerance."

In general, younger investors have a higher risk tolerance. They are able to recover from short-term losses more easily. Their long timeline lets them use risk to their advantage, maximizing their potential return. Investors nearing retirement do not have the luxury of time. Because a sudden drop in their portfolio could be devastating to their finances, they tend to have a low risk tolerance and make conservative investments.

Although time is usually the major factor in determining risk tolerance, the choice is up to the investor. All investors need to accept some risk, but not everyone feels safe taking on the same amount. Some investors would rather save more of their income in exchange for the security of low-risk investments. Others might want to spend more money while they are young and make up for any losses later in life. Either method can be successful, but a financial professional should always be consulted when trying to determine risk tolerance.

Opportunity for Growth

Though the term gets used in various ways, financial "risk" is always about uncertainty. Risky assets, portfolios and financial plans are those that are hardest to predict. However, the potential for loss is also the potential for gain. Investors seeking returns must learn how to wield risk properly. By understanding and balancing risk and return, an investor can suitably grow his or her investments.

Whenever dealing with risk and return on the market, consult your financial advisor. Our expertise can help guide your investment decisions and determine the amount of risk ideal for your portfolio.

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