Risks

There are risks you can't control. Like something called systemic risk, for instance. If you learn to accept risk as a normal part of investing, you can develop asset allocation and diversification strategies to help ease the impact of these situations. Knowing how to tolerate risk and avoid panic selling is part of a smart investment plan.

Uncontrollable Risks

Market Risk: This is the possibility that the financial markets will drop in value and create a ripple effect in your portfolio. For example, if the stock market as a whole loses value, chances are your stocks or stock funds will decrease in value as well until the market returns to a period of growth. Market risk exposes you to potential loss of principal, since some companies don't survive market downturns. But the greater threat is the loss of principal that can result from selling when prices are low.

Interest Rate Risk: This is the possibility that interest rates will go up. If that happens, inflation increases, and the value of existing bonds and other fixed-income investments declines, since they're worth less to investors than newly issued bonds paying a higher rate. Rising interest rates also usually mean lower stock prices, since investors put more money into interest-paying investments because they can get a strong return with less risk.

Recession Risk: A recession, or period of economic slowdown, means many investments could lose value and make investing seem riskier.

Currency Risk: Currency fluctuations affect the value of your overseas investments and may also affect the value of domestic investments in companies whose products can be undersold by overseas producers.

For example, suppose that $1 is worth 1 euro. If the dollar increased in value, you might be able to get 1 euro for only 90 cents. That's good if you're shopping in Europe. But if you bought a stock based in euros and the dollar grew stronger, the stock would be worth less to you than to someone who invested using euros. Using this example, a capital gain of 1,000 euros would be worth just $900 in US dollars. On the other hand, if the dollar loses ground against various currencies, you may make money on your existing investments that are based on those currencies, but it will cost more to purchase additional amounts of these investments.

Political Risk: With the increasing interaction of the world's markets, political climates around the world can affect the value of your domestic and international investments. A period of instability, for example, can drive the value of your investments down, while political stability and growth can increase their value.

Risk Tolerance

Everyone handles risk differently. That's because some people can Live with or can afford to take more risk than others. The younger you are, the more investment risk you generally can afford to take. That's because you have the time to wait for a rebound when there is a downturn in the market. But if you've retired or are nearing retirement, you may be counting on income from your investments. You're likely to want to avoid the risk of losing principal even if you make yourself more vulnerable to inflation risk.

Your life situation also plays a role in how much risk you are willing to take. If you have children who will be going to college in the next few years, or aging parents who depend on you for financial support, you may need to keep more of your portfolio in stable, fixed-income investments, to help cover your short-term expenses. Or, if you're taking the risk of building your own business, you might be more comfortable making investments that you know you can count on.

Your personality matters also. There's no way around the fact that most investments will drop in value at some point. That's what risk is all about. Most experts agree that it's counterproductive to make investments that either make you so nervous you can't sleep or mean you'll sell in panic at the first sign of a downturn.

There are some things you can do to comprehend your risk tolerance. You can build it or compensate for it in several ways:

- Start investing slowly in investments that don't require constant monitoring and gradually expand your horizons.

- Keep track of stock and stock mutual fund performance, so you get used to their values moving up and down.

- Keep track of what's happening in the markets at large.

- Discuss what your impressions of the market are, and talk about any changes you're considering in investment strategy with a financial adviser.

Risks You Can Control

If you want the financial security and sense of accomplishment that comes with investing successfully, you have to be willing to take some risk. In most cases, risk means the possibility you'll lose some or even all of the money you invest. Taking risk doesn't mean you have to take flying leaps into untested waters; it means anticipating what the potential problems with a certain investment might be, and putting a strategy in place to manage, or offset them.

There is some risk you can avoid. For instance, there's risk in concentrating all of your savings in just one or two stocks or bonds. There's investment risk in choosing to put your money into one company rather than another. And there's management risk that a company's officers may make serious errors. These are examples of what is known as nonsystemic risk because the potential problem lies in the individual investment, not the investment marketplace.

You can manage nonsystemic risk by allocating and diversifying your portfolio, or spreading your assets among a variety of investments. That way, if one of your investments goes down significantly in value, those losses may be offset to some degree by gains, or even stable values, in some of your other investments.

Being Too Safe: One of the most common investment risks people fall prey to is not taking enough risk. If you invest very conservatively; or don't invest at all because you fear losing some of your principal, you run the risk of not meeting your goals and even running out of money during retirement. That's because the rate of return you'll realize will be so low that your investments won't outpace inflation. Think about that. Is the greatest risk the risk of running out of money?

Volatility: The way you control volatility is by diversifying. Over the course of a day, a month, or a year, the price of your investments may fluctuate, sometimes dramatically. This constant movement, known as volatility, varies from investment to investment, with some investments being significantly more volatile than others. For example, stock and stock mutual funds tend to change price more quickly than most fixed-income investments, such as bonds. But it's not always that simple. The price of stock in large, well-established companies (known as blue chips) tend to change more slowly than stock in smaller or newer companies. Also, some low-rated, high-yield bonds fluctuate in price as least as often as stocks, and offer some of the same opportunities for gain and for loss.

Volatility poses a significant psychological investment risk in the short term. If you can wait out downturns in the market, chances are that the value of a diversified portfolio will rebound, and you'll end up with a gain. If you look at the big picture, you'll discover that what seems to be a huge drop in price over the short term evens out over the long term. In fact, over periods of 15 or 20 years or more, stocks, many of the most volatile investments over the short term, have always increased in value.