

Independent Investor

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Is It Time to Rethink Risk?

If you mention risk in today's tumultuous market climate, most people probably think of their rapidly shrinking investment accounts. But in reality, investment risk takes many forms, and each can affect how you pursue your financial goals. The key to dealing with investment risk is to learn how to manage it — with help from your financial advisor.

The LPL Financial Glossary of Financial Terms defines risk as "the chance that an investor will lose all or part of an investment." While investment risk does refer to the general risk of loss, it can be broken down into more specific classifications. Familiarizing yourself with the different kinds of risk is the first step in learning how to manage risk within your portfolio.

Types of Risk

Risk comes in many forms, including:

- **Market risk:** The likelihood that the value of a security will move in tandem with its overall market. For example, if the stock market is experiencing a decline, the stocks in your portfolio may decline as well. Or if bond prices are rising, the value of your bonds may also go up.
- **Interest rate risk:** Most often associated with fixed-income investments, this is the risk that the price of a bond will fall with rising interest rates.
- **Inflation risk:** This is the risk that the value of your portfolio will be eroded by a decline in the purchasing power of your savings, as a result of inflation. Inflation risk needs to be considered when evaluating

conservative investments, such as bonds and money market instruments as long-term investments. While your investment may post gains over time, it may actually be losing value if it does not at least keep pace with the rate of inflation.

- **Credit risk:** This type of risk comes into play with bonds. It refers to a bond issuer's ability to repay its debt as promised when the bond matures. Bonds are given credit ratings by agencies such as Moody's and Standard & Poor's. In general, the higher the rating, the lower the credit risk. Junk bonds, which are not investment grade securities generally have the lowest ratings, are among the riskiest in terms of credit. People who invest in them typically seek higher yields to compensate for their higher credit risk.
- **International risk:** International investments also involve additional risks, including the possibility of fluctuating currency values (currency risk) and the risk that political and economic upheavals may affect a country's markets.

Manage Market Risk by Diversifying

The process of diversification — spreading your money among several different investments and investment classes — is used specifically to help minimize market risk in a portfolio.¹

Also consider the potential benefits of selecting investments from more than one asset class. For instance, when stocks are particularly hard hit due to changing conditions, bonds may not be affected as dramatically. In part, that may be because bond total returns may be tied more to income (which can cushion a portfolio) than price changes. Historically speaking, the total return of stocks has consisted of both income and capital appreciation, while the total return of bonds has been made up primarily of interest income.

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Match Investment Choices to Your Goals

Before you can decide what types of investments are appropriate from a risk perspective, you need to evaluate your investment goals. Is your goal preservation of principal, generating income for current expenses or building the value of your principal over and above inflation?

Next, examine your investment time horizon, and consider how comfortable you may be riding out short-term losses. Remember, the longer your time horizon, the more volatility you may be able to tolerate in your portfolio.

At the same time, long-term investors need to be concerned about inflation. That is why their portfolios may be more heavily weighted in stock investments, as these have historically provided the highest long-term returns and outpaced inflation by the widest margin,

although past performance does not guarantee future returns. These investors may also devote some money to bonds and money market investments to help balance the higher risks associated with stocks.

On the other hand, people who need to rely heavily on the income from their portfolios, such as retirees, may seek to maximize income and minimize risk of short-term losses. Their portfolios may be weighted in high-quality, lower-risk bond and money market investments, with some stocks in the mix to maintain growth potential.

¹ Remember, there is no guarantee that a diversified portfolio will enhance overall returns or outperform a nondiversified portfolio, and that diversification does not eliminate market risk.

This article was prepared by Standard & Poor's and is not intended to provide specific investment advice for any individual. Consult with me if you have any questions.