Learning to live with risk

People who are averse to risk often consider cash investments such as money market funds and CDs to be worry-free, "safe" investments. Today, especially, volatile markets and the fear of a lengthy recession are likely to make these choices, for some, the correct path to take. But ever-present inflation—even low inflation—eats into the buying power of your money. Only if your investment surpasses inflation are you gaining ground.

The truth is, all investing involves risk. But risk shouldn't keep anyone from investing. Successful investors learn how to manage their risk by finding a comfortable balance between the risks that they are willing to take and the rewards commensurate with those risks.

Stock risks

Historically, stocks have offered investors the highest long-term total returns. Of course, as we have seen recently, the results can be very different when measured in the short term.

What kinds of risk do investors in equities face?

- *Company and industry risk*. If the company issuing the stock fares badly, or is held in low regard for some reason, the price is likely to fall. And a falloff in business in an industry can affect the price of a company's shares, even if the company itself is not faring that badly.
- *Market risk*. Certain factors may cause the market as a whole to move. They may be economic—for example, expected or reported rises or falls in economic growth—or national or international events. Of course, factors that can depress a stock's price may have a flip side—good news can send the market, as well as the investor's equity holdings, upward.
- *Liquidity risk*. There is always the danger with any investment of not being able to get out of the investment conveniently, at a reasonable price. When forced to sell a holding suddenly, an investor could suffer a significant loss. (This risk is not limited to stocks alone.)

Bond risks

Bonds generally are perceived as a lower-risk investment than stocks. When bonds are held to maturity, bondholders should receive back their principal, in addition to the income earned on the bond.

Default and credit risk. Here's why we said "generally": It's possible that a company or other bond issuer will fail to make scheduled payments on its debt or not pay the bondholder back all or

part of his or her principal. The risk of default is, perhaps, more on some people's minds now as municipalities struggle with large budget deficits.

Interest-rate risk. Bond prices are sensitive to changing market conditions. When interest rates rise, bond values fall. Therefore, when new bonds pay more income than bonds that an investor owns, the risk arises that if the investor has to sell the bonds, he or she may have to do so for less than what was paid.

Managing risk

The first step in risk management is to determine how much risk you can live with—and stick with. Many factors will contribute to your decisions about how much risk to take: Your age, your knowledge about investments, your attitude toward risk are just a few of them.

If you know your comfort level, you can take the necessary actions to manage the risks that you are willing to accept. For instance, developing an asset allocation strategy and diversifying your investment capital among a mix of stocks, bonds and cash reserves are important steps in the process.

To find the right level of risk is every investor's challenge, but one that needn't be faced alone. Calling upon the knowledge and experience of our professionals to assist you will help you meet that challenge.

Any developments occurring after January 1, 2014, are not reflected in this article.