

DOES RISK Mean Reward?

by Matt Hickey

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In 2008, the global financial crisis that began devastating the world's finances caused one of the most widespread and traumatic shake-ups within the stock and bond market in years. With the financial disaster still fresh in many investors' minds, they have been understandably hesitant to trust their hard-earned and diligently saved resources to the market. While the declines in 2008 and early 2009 had an upsetting impact on account balances, it has been softened a bit by a broad and strong recovery in many investors' portfolio values. However, this improvement cannot overshadow the fact that the psyche of investors is still very fragile, which was apparent throughout the volatile summer of 2011 when investors weighed the real world impact of our country's debt load. A multitude of factors, both political and economic, led to some of the most dramatic swings in the stock market during the last 3 years. Despite this nerve-racking unpredictability, it is crucial to remember that if you risk nothing, you also gain nothing.

Know your risks

Market risk is most often associated with "price volatility" (how much a holding's value fluctuates over a period of time). The presence of market risk can easily be measured on a month-by-month basis by simply looking at your investment statements. It can be monitored even more closely on a day-to-day basis by checking your account balances online, or a minute-to-minute update if you are tracking individual positions that are traded on market exchanges around the world and around the clock. There are

several types of risk that can impact your portfolio. While market risk might be at the forefront of our minds, there are 2 key threats that demand our attention: *interest rate risk* and *inflationary risk*.

Interest rate risk

Most well-rounded portfolios have a combination of equities (stocks, exchange traded funds and mutual funds) and fixed income instruments (bonds or bond funds). The fixed income portion of portfolios will most likely be impacted by interest rate risk. Interest rates have been at all time lows for nearly 3 years, resulting in consequences that are both positive (low rates for mortgages and other lending instruments) and negative (lower yield or income on general bond portfolios). It is important to be aware of the risk your bond portfolio might be subjected to in the event interest rates do indeed rise off of these record low levels. If/when interest rates do increase, the price of lower yielding bonds will fall, ultimately impacting portfolio values. Although it is necessary to maintain fixed income positions to help balance your overall risk profile, it is wise to be mindful of the possible presence of interest rate risk in your portfolio.

Inflation risk

Inflation exists in every part of the world and impacts nearly every transaction. From the price of gas to the cost of a night out for dinner, living expenses are continually rising. Let's put the significant impact of inflation into perspective: If you bury \$1 million in your backyard today, 25 years from now the

purchasing power of that money will be worth less than \$500,000 (assuming a 3% inflation rate).¹ Therefore, it is crucial to pay attention to the impact inflation has on the power of your portfolio, as well as your pocketbook.

The chart below illustrates the gains (and pains) we experience when taking on some market risk. However, one of the most certain ways to erode your purchasing power is to succumb to inflation and take on *no* risk at all. Failure to take on a certain degree of risk can leave you with no return. Placing too large of an allocation into money market funds or savings accounts that are returning fractions of a percent for lengthy periods of time can introduce a substantial amount of inflation risk to your portfolio.

Weigh your risks

Taking risk, especially when it involves substantial amounts of money, is intimidating. However, seeking professional guidance and researching investment strategies can make the process less daunting. While there will always be a degree of uncertainty surrounding the market, it is important to remember that, over time, a disciplined and well-balanced portfolio can help you meet your financial planning goals. Weighing your risks, avoiding their pitfalls and investing properly can help boost your confidence in the market, as well as your wealth portfolio.

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¹ Krantz, Matt. *USA Today* website. "Inflation Risk Can Hurt Portfolio That Plays it Too Safe." March 17, 2011. Accessed August 12, 2011 at www.usatoday.com/money/perfi/columnist/krantz/2011-03-17-playingyourinvestmentssafe.htm

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