

Second Quarter 2007 Knowledge College

Understanding Risk

To achieve financial goals and invest successfully, most investors have to be willing to take on some risk. Understanding how to tolerate risk and avoid panic selling when the market hits its inevitable bumps is a critical component of a successful investment strategy.

Some risks you can avoid....

Non-systematic risk is risk that lies in an individual investment, as opposed to the investment marketplace. An example would be the risk inherent in concentrating all of your assets in just one or two securities.

By diversifying your investments and allocating money among different asset classes you can reduce and even eliminate non-systematic risk.

Some risks you can't control...

Systematic risk is risk that is inherent to the market. If you're in the market, you have some exposure. While risk is a normal part of investing, **you can develop asset allocation and diversification strategies to help reduce its impact.**

▶ *Market Risk*

Financial markets can drop in value and create a ripple effect in your portfolio. Market risk exposes you to potential loss of principal, since some companies don't survive market downturns. The greatest 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, the value of existing bonds and other fixed-income instruments decline, since they're worth less to investors than newly issued bonds paying a higher rate. Rising interest rates may also mean lower stock prices, since investors may put more money into interest-paying investments because they can get a strong return with less risk.

▶ *Inflation Risk*

Inflation or purchasing power risk is **the chance that the value of your money won't keep pace with inflation.** Inflation is a constant, steady erosion of your money's value. The rate of inflation varies -- some years it's higher than in others. But the cost of living generally goes up, so we all need more money just to stay even.

▶ *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 competitors.

▶ *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 can drive the value of investments down, while political stability and growth can increase their value.

Managing Risk

▶ *Choose Appropriate Risks (finding your sleep threshold)*

Know and understand the risks involved in various investment vehicles. Make sure you are comfortable with the risk level of the investments you choose.

▶ *Manage Risk – Don't Try To Escape It*

Diversify; a variety of investment vehicles and securities lessens the negative impact of one investment that stumbles. You want to diversify by security, sector, asset class and investment style. Invest over time to take advantage of market fluctuations. Monitor your investments to ensure that the risk/reward parameters you have set have not changed and **maintain a disciplined approach to re-balancing** your portfolio's assets.

▶ *Stay the Course*

Some investors rush into the market when it is doing well and then unload their shares at the first hint of decline. While it is important to be knowledgeable about market movements, **attempting to chase returns can be risky business**. Few professional investors, if any, consistently "time" the market correctly. Individual investors are notorious for timing it incorrectly, buying in droves at market tops and selling at market bottoms. For significant investment goals, **you must be willing to commit for the long term**. The longer you remain with an investment, the greater its ability to withstand the market's normal fluctuations.

▶ *Put Risk in Perspective*

Whether you are sampling a cup of steaming coffee or beginning the first day of a new job, you encounter some form of risk. In the final analysis, only you can decide what you are willing to chance for meaningful rewards. Certainly no one should build an investment portfolio that causes them to lose sleep – you must feel comfortable about your investment objectives and the methods you've chosen to achieve them. Regardless of your investment goals, you can benefit from an understanding of risk. **Use proven risk management techniques and commit to your chosen investment plan, and you may find risk to be a valuable ally.**

For more information, please contact any of the professionals at DiMeo Schneider & Associates