Four Things to Know About Risk

Whether you're already investing or are just thinking about it, you should understand risk and the role it plays in a portfolio. And although it may seem simple enough on the surface, risk can be one of the most difficult concepts to grasp – especially for new investors. To help clear things up, here are four things you should know:

1. Risk has many faces.

Usually when people talk about risk, they're referring to investment risk: You purchase a stock at $50 a share, for example, and a year later it's worth only $25. Investment risk is relatively easy to understand, and it's measureable based on the ups and downs in an investment's price. The more volatile it's been, the more risky the investment is considered to be.

Unfortunately, investment risk is only one investors face. There are plenty of others that aren't so easy to understand or measure. For example, there's:

Market risk. While investment risk has to do with a specific investment, there's also the risk that the entire market will decline – remember what happened to stocks during the Great Recession – and pull your investment down with it. That's market risk.

Inflation risk. Inflation is the overall increase in prices in an economy. It creates the risk that an investment's return won't be enough to overcome its impact. For example, inflation runs 2% a year and your investment returns only 1%. That means you have lost "purchasing power." As a result, even with your returns, it would buy less at the end of the year than at the beginning.

Opportunity risk. Some investors believe you can avoid risk by investing conservatively. However, there's opportunity risk, which is the possibility of missing out on the chance to earn better returns by being more aggressive.

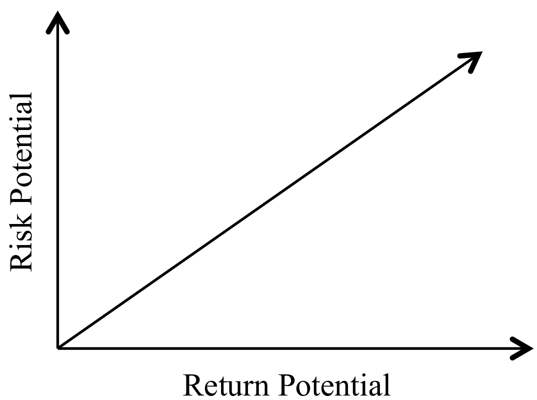
This is just a small sampling. There are other risks, including some specific to certain types of investments. For example, bond investors face default risk – the risk the issuer will fail to make interest payments or repay the bond's par value at maturity.

2. It’s usually linked with return.

Possibly the most important thing to understand about risk is its relationship with return. The two generally go hand-in-hand:

- If you put money into a low-risk investment, you should probably expect lower returns.
- If you choose a higher-risk investment, you possibly could anticipate better returns.

Of course, things don’t always work out that way. When you put money into a high-risk investment, you may not get better returns. In fact, you could end up losing your entire investment. But many investors continue to include riskier investments in their portfolios, often for higher return potential.



In general, as an investment’s return potential increases, so does its risk.

3. You should determine your tolerance.

Your risk tolerance is simply how much risk you can comfortably live with in your portfolio. It sounds simple enough, but determining your risk tolerance can be challenging. There are tools, like questionnaires, available to assist you. In addition, one indicator that you’ve exceeded your risk tolerance is when you find your investments’ performance is keeping you awake at night – especially when there’s market volatility.

You may have a relatively low risk tolerance, and that’s OK. However, staying within it and having a reasonable chance of reaching your goals may mean you need to adjust your objectives (having, say, $750,000 at retirement instead of $1 million). You may also need to lengthen your time horizon, which is how long you have until you need to tap into your investments. For example, you may decide you need to work until 68 instead of 65 so you have longer to invest.

4. Help is available.

Because risk is complicated, and it’s only one aspect of investing, you may need a professional financial advisor to help with building your portfolio. Look for one who will take the time to get to know you, including your risk tolerance, before recommending an investment plan.

This article was written by Wells Fargo Advisors and provided courtesy of David M. Gustin, AAMS®, Vice President-Investments in Melville, N.Y. at 631-753-4533