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Managing Risk in Your Portfolio

In order to figure out how to manage risk, you must first understand it. Investment risk -- or the risk of losing investment value -- comes in many forms. Four major components of investment risk are: (1) market risk, the likelihood that a security's value will move in tandem with its overall market; (2) interest rate risk, the risk that the price of a bond will fall with rising interest rates; (3) inflation risk, the chance that the purchasing power of an investment will be eroded by inflation; and (4) credit risk, the risk that a bond issuer will not be able to repay its debt when the bond matures.

There is also the risk of investing too conservatively -- not getting a high enough return to provide for your financial future.

To effectively manage these elements of portfolio risk, you need to evaluate your personal investment goals and match these goals to your portfolio risks. Factors such as your investment time horizon and risk comfort level also must be considered. These will determine how much and what kinds of risk you are willing to take. A financial advisor can help you select vehicles that are suitable for your goals.

To most people, "risk" evokes negative images -- driving faster than the speed limit, placing bets on "a long shot," or traveling alone to unfamiliar places. Mention risk in terms of investing and people might think about losing their life's savings. But in reality, investment risk comes in many forms, and each can affect how you pursue your financial goals. The key to dealing with investment risk is learning how to manage it.

Step One: Understand Risk

Barron's *Finance and Investment Handbook* defines risk as the "measurable possibility of losing or not gaining value." Fear of losing some money is probably one reason why people may choose conservative investments, even for long-term savings. 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 it within your portfolio.

Varieties of Risk

Risk comes in many forms, including:

- **Market risk:** Also known as systematic risk, market risk is 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 stock mutual funds 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 or the price of a bond fund 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, bond funds, and money market funds,[1] 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. Investment in a money

market fund is neither insured nor guaranteed by the U.S. government, and there can be no guarantee that the fund will maintain a stable $1 share price. The fund's yield will vary.

- **Credit risk:** This type of risk comes into play with bonds and bond funds. It refers to a bond issuer's ability to repay its debt as promised when the bond matures. Bonds and bond funds are given credit ratings by such agencies as Moody's and Standard & Poor's. In general, the higher the rating, the lower the credit risk. Junk bonds, which 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 investments 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.

Step Two: Diversify

The adage "Don't put all your eggs in one basket" is applicable to the realm of investing. 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. Because they invest in many different securities, mutual funds may be ideal ways to diversify. Selecting more than one mutual fund for your portfolio can help further reduce risk. Also consider the potential benefits of selecting investments from more than one asset class: 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 (see chart). Remember that diversification does not eliminate market risk, and there is no guarantee that a diversified portfolio will enhance overall returns or outperform a nondiversified portfolio.

Step Three: Match Investments to Goals

Before you can decide what types of investments are appropriate from a risk perspective, you need to evaluate your savings goals. Is your goal preservation of principal, generating income for current expenses, or building the value of your principal over and above inflation? How you define your goals will enable you to find an appropriate balance between the return you hope to achieve and the risk you are willing to assume.

Examine your time horizon for meeting your goals, and consider how comfortable you may be riding out short-term losses in the value of your investments. 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. If you are investing your retirement funds, you may also be concerned about building capital over the long term.

For example, investors pursuing long-term goals (such as retirement) may be most concerned with long-term growth and minimizing inflation risk. 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.[2] 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 already in retirement may need to rely heavily on the income from their portfolios. Therefore, they 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]

	Market Risk	Inflation Risk	Credit Risk
Stocks	High	Low	N/A
Government Bonds	Medium	High	Low
Money Market Funds	Low	High	Low
Small-Cap Stocks	High	Low	N/A
High-Yield Bonds	High	High	High

The Risk of Not Investing Appropriately

When thinking about how to balance risk and return in your portfolio, don't forget that the risk of loss is not the only kind of risk. Give some thought to the risk of investing too conservatively and not reaping a high enough return to provide for your financial future. Also be aware of investing in instruments that may be too risky for your shorter term goals. A financial advisor can help you select vehicles that are suitable for your goals.

As you consider each particular investment, research its performance history and risk characteristics. For example, if it's a stock fund, how drastically has it responded to drops in the market? How long has it taken to recoup losses? How has it performed over a time frame similar to your own? For a bond fund, consider also the average maturity of bonds held in the particular fund.

Using Risk to Its Full Potential

In life, almost every attempt at success involves some risk -- and your investment strategy is no different. By devoting time to examining your goals, conducting some research, and working with a financial advisor, you can learn how to manage risk in your portfolio by choosing appropriate investments.

Source/Disclaimer:

[1]An investment in a money market fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the fund seeks to preserve the value of your investment at $1.00 per share, it is possible to lose money by investing in the fund.

[2]Sources: Standard & Poor's; the Federal Reserve. Stocks are represented by the total returns of the S&P 500 index, an unmanaged index considered representative of the stock market. Bonds are represented by long-term (10+ years) Treasuries. Inflation is represented by the Consumer Price Index. Results include reinvested dividends. Investors cannot invest directly in any index. Past performance is no guarantee of future results.

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