

FINANCIAL PLANNING BUILDING BLOCKS

What's one of the biggest investment risks? I would say it's the risk that your portfolio growth doesn't keep pace with inflation (called purchasing power risk). This means that a dollar today spends like something less than a dollar tomorrow. If we use that criteria for investment risk, stocks historically have been one of the least risky long-term investments. Now, not all stocks have the same level of investment risk, so let's ask the question, "What makes one investment riskier than another?" The answer includes such factors as: the economy, a company's fundamentals (financial status, product, management, etc.), market perception, and several other factors. Considered together, these factors all contribute to *investment risk*.

Investment risk can be defined as the uncertainty that an investment's desired return will be achieved. No investment, even the *safest*, is completely without risk. Investment risk can be divided into two parts – systematic risk (represented as *beta*) and unsystematic risk.

Systematic risk, also known as *non-diversifiable risk*, refers to the portion of investment risk that is caused by factors affecting the prices of all comparable investments. Types of systematic risk include market risk, interest rate risk, reinvestment rate risk, purchasing power risk, and currency (exchange rate) risk. By definition, systematic risk *cannot* be eliminated.

Unsystematic risk, also known as *diversifiable risk*, represents the portion of investment risk that can be reduced through diversification. Such factors as management capabilities, labor strikes, and consumer preferences cause unsystematic (unique or peculiar) variability of return in a firm. Types of unsystematic risk include: business, financial, default, and liquidity risks.

Liquidity refers to an investor's ability to easily convert an asset to cash at a predictable, stable price. As a general rule, increased liquidity reduces an investment's return potential; in other words, you pay a price for liquidity.

Marketability refers to the ability to buy and sell an asset. The key point to remember about marketability is that, although the investor can readily sell the asset, there is no guarantee as to the price at which the sale will be made. Some degree of marketability is desired for most securities (you have to sell the security in order to make a profit).

A general investment principal is: increased risk tends to yield increased returns. A good investing model is to balance desired return with the anticipated risk of a given investment. The impact of an investment's risk-level can often be moderated by the length of time you hold the investment. Long-term investment horizons normally reduce any negative effects of investment risk. This is the concept behind the *buy-and-hold* investment strategy.

A useful plan is to build an investment portfolio with solid fundamentals, that fits your risk tolerance level, and hold onto those investments for an extended period of time (as long as the fundamentals remain solid). Add regularly to your well-constructed, diversified portfolio and you should be pleased with your long-term results. Current events have caused many to question this basic strategy, and with good reason. It certainly seems as if everything has been turned on its head. However, it is still a good basic investing philosophy for many people, and market downturns often present good buying opportunities. Just be sure to focus on the *well-constructed, diversified* part and evaluate regularly. Consulting a competent advisor may also be a very good idea.