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Manage Risk in your Portfolio

Familiarizing yourself with the different kinds of risk is the first step in learning how to manage it within your portfolio.

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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 savings. 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." The fear of losing money is a primary reason why people might choose conservative investments, even for long-term goals. 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 because investors are willing to pay a premium for older bonds that offer a higher yield, compared to newly issued bonds with lower coupon rates.
- **Interest rate risk.** Most often associated with fixed income investments, this is the risk that the price of a bond or bond fund will fall as interest rates rise. (Keep in mind that bond prices and interest rates have an inverse relationship.)
- **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 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. Bond ratings, which are assigned by independent credit rating agencies such as Moody's and Standard & Poor's, are a measure of a bond issuer's creditworthiness and their ability to repay the bond's principal and interest in a timely fashion. 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

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of credit. People who invest in them typically seek higher yields to compensate for their higher credit risk.

- **International and currency risk.** Investing internationally involves 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. However, international investments can also provide broader diversification to a portfolio that invests primarily in domestic securities, as discussed below.

Step Two: Diversify

The adage, "don't put all your eggs in one basket" is applicable to the realm of investing. Diversification—the process of spreading your money among different investments and asset classes—is used to help reduce market risk in a portfolio. Because a single mutual fund invests in many different securities, it can provide a level of diversification on its own. However, selecting several mutual funds that invest in different sectors, markets, and asset classes can help to further reduce risk.

Adding international investments to a portfolio of domestic stocks and bonds is a good example of how diversification may help reduce overall portfolio risk. By spreading investments across different markets, investors potentially reduce the risk of loss associated with investment in a single country or region. That's because when one country or region experiences an economic downturn, investments in other areas may perform well, potentially reducing overall portfolio losses and smoothing out returns.

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 investment goals. Are you seeking preservation of principal, income for current expenses, or growth to outpace inflation? Your answer will help you determine an appropriate balance between the return you hope to achieve and the risk you are willing to assume.

Next, examine your time horizon for meeting your goals and consider how comfortable you may be riding out any short-term losses in the value of your investments. Generally, the longer your time horizon, the more volatility you may be able to tolerate in your portfolio. For example, investors pursuing long-term goals (such as saving for retirement) may be most concerned with long-term growth and minimizing inflation risk. As a result, their portfolios may be more heavily weighted in stock investments. Although past performance does not guarantee future results, stock market investments have historically provided the highest long-term returns and outpaced inflation by the widest margin. These investors may also allocate some money to bonds and money market investments to help balance the higher risks associated with stocks.

Risk Involved in Various Investments

	Market Risk	*Inflation Risk*	*Credit Risk*
Stocks[3]	High	Low	N/A
Government Bonds[4]	Medium	High	Low
Money Market Funds[1]	Low	High	Low
Small-Cap Stocks[5]	High	Low	N/A
High-Yield Bonds[6]	High	High	High

On the other hand, those currently in retirement may need to rely heavily on the income from their portfolios. They may seek strategies to help maximize income and minimize the 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.

The risk of not investing appropriately

When thinking about ways to balance risk and return in your portfolio, don't forget that investment losses are not the only types of risk investors face. Being too conservative may jeopardize your financial future if returns don't outpace the rate of inflation. Also, beware of investing in instruments that may be too risky for your short-term goals. For example, you want to avoid drawing money from long-term assets to fund short-term goals, especially in a declining market.

As you consider different investments, research each investment's 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 recover losses? How has it performed over a timeframe similar to your own? For a bond fund, be sure to consider 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 an experienced wealth advisor, you can learn how to choose appropriate investments to help manage risk in your portfolio.

To learn more about ways to simplify complex financial challenges and pursue the Return on Life® you and your family desire, contact the Return on Life Wealth Partners team at **440.740.0130** or visit us online.

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[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 Standard & Poor's Composite Index of 500 Stocks, 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. Indexes are unmanaged, do not incur fees or expenses, and cannot be invested into directly. Past performance is no guarantee of future results.

[3]Stock investing involves risk including possible loss of principal.

[4]Government bonds and Treasury bills are guaranteed by the U.S. Government as to the timely payment of principal and interest and if held to maturity, offer a fixed rate of return and fixed principal value.

[5]Small capitalization stocks may be subject to a higher degree of risk than more established companies' securities. The illiquidity of the small-cap market may adversely affect the value of these investments.

[6]High yield/junk bonds are not investment grade securities, involve substantial risks and generally should be part of a diversified portfolio for sophisticated investors. There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not ensure against market risk. Investing in mutual funds involves risk, including possible loss of principal. Investments in specialized industry sectors have additional risks, which are outlined in the prospectus. "Investors should consider the investment objectives, risks, charges and expenses of the investment company carefully before investing. The prospectus contains this and other important information about the investment company. You can obtain a prospectus from your financial advisor. Read carefully before investing.

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