INVESTMENT CONCEPTS, INC.
SAGEPOINT FINANCIAL

Types of Risk

What is risk?

In the investment world, risk generally is associated with uncertainty. It refers to the possibility that you will lose some or all of your investment or that an investment will yield less than its anticipated return. Simply stated, risk is the degree of probability that an investment will make or lose money. Every investment carries some degree of risk because its returns are unpredictable. The more volatile an investment is--the more unpredictable its returns--the riskier it is generally considered to be.

Each investment is subject to all of the general risks associated with that type of investment. These risks are called systematic risks and are caused by conditions outside a company or industry (e.g., society or politics) that affect all similar types of companies. These conditions are generally difficult for the investment issuer to control, and individual securities selection within a given asset class can do relatively little to reduce those risks. You simply must be aware of them when choosing which investments are right for you.

Risk also arises from factors and circumstances that are specific to a particular company, industry, or class of investments. These are called unsystematic or diversifiable risks. As the name implies, unsystematic risks can be reduced by diversifying your investment portfolio (though diversification alone cannot guarantee a profit or ensure against the possibility of loss).

What are the types of systematic risk?

Market risk

The stock market can be a great way to build wealth, but it can also plummet in little or no time at all.

Specifically, market risk refers to the change in the price of securities caused by fluctuations in overall market conditions or in a specific sector of the market, brought on by outside forces. More simply stated, market risk is another name for losses due to the falling prices of securities.

What causes the price of securities to fall? Of the many possible causes, here are a few:

- National events (e.g., war or disaster)
- Political events (e.g., a presidential election)
- Economic factors (e.g., interest and unemployment rates)

A bear market refers to a general downward trend to market prices. A bull market refers to a rise in overall market prices.

Interest rate risk

Interest rate risk is the risk of loss due to variation in the price of bonds (or preferred stock) because of changes in interest rates. When interest rates rise, bond prices fall; when interest rates go down, bond prices rise. The bond you bought when interest rates were low is worth less as interest rates increase because new bonds will generally offer the new, higher interest rates, thus reducing demand for older bonds.

Bonds with shorter maturities are less susceptible to interest rate risk. Conversely, bonds with longer maturities generally offer higher yields, but also have the potential for greater price swings than those of shorter maturities.

Purchasing power, inflation risk, or price level risk

Purchasing power risk, also referred to as inflation or price level risk, refers to the possibility that the return on your investments won't keep pace with increasing price levels. As prices rise, the value of a dollar falls, resulting in a decreased ability to purchase goods and services.

People who hold cash, savings accounts, and bonds assume this kind of risk. The danger is that their money may not grow enough over the years to allow them to achieve their financial goals.

Example(s): Martha retires at age 62. She receives $1,000 a month from her pension and $1,500 a month from her investments in certificates of deposit (CDs) and bonds. Martha's total monthly income of $2,500 allows her to live quite comfortably. Twenty years later, Martha is a healthy 82 years of age. She still receives $2,500 a month from her pension and investments, but, even though her lifestyle has not changed, her monthly expenses have climbed to over $3,000 because of inflation. She is dipping into principal to cover the excess cost. Martha worries about what she will do when her investments are gone.

Social risk

Social risk refers to the possibility that a segment of society will institute boycotts, litigation, publicity campaigns, or lobbying efforts against a company due to its social policy or business practices. The actions of society can negatively affect that company's performance. Tobacco, energy, gaming, and weapons companies often face this type of risk, as do companies that face environmental or discrimination concerns.

Example(s): A large oil company ships crude oil overseas in giant tankers. One night, while pulling into port, the tanker's captain miscalculates and crashes into another tanker, opening a hole in his own ship. Millions of gallons of oil spill into the sea and wash up on the shore. The cleanup effort costs millions of dollars, paid by the country's taxpayers. The oil corporation refuses to reimburse the government for the expense. In reprisal, the country's driving population boycotts the oil company's service stations for the next several years, causing a great economic loss to the company.

Reinvestment rate risk

Reinvestment rate risk refers to the possibility that you will have to reinvest funds at a lower rate of return than the investment originally earned.

Example(s): Your six-year, 9 percent interest CDs mature. You would like to reinvest the money in new CDs. At that time, however, CDs are earning only 5 percent interest. You must either accept a lower return or find an alternative investment.

Exchange rate or currency risk

Exchange rate or currency risk arises because of fluctuating foreign exchange rates. These fluctuations may affect the value of foreign investments or profits when converting them into U.S. currency. If you have investments denominated in a foreign currency, they may rise in value if the dollar falls; conversely, if the value of the dollar rises, the corresponding drop in the relative value of the foreign currency could cause your investments to lose value.

Political risk

Political risk refers to possible changes in the government or legal environment. For example, taxes may rise, tariffs may be imposed, or wages and prices may be controlled. All of these things could result in reducing a company's profits.

What are the types of unsystematic risk?

Business (or industry) and business failure risk

Business or industry risk refers to the risk associated with a particular company or industry. Business risk can be caused by changes in a company's sales due to operating problems, such as a strike, an unfavorable outcome of litigation, or technical obsolescence. Industry-specific risks arise because some industries are inherently more uncertain than others. They may face greater risks due to accidents, product liability, or the innovative nature of their business. For example, a company developing new drugs likely has a greater inherent risk than a company manufacturing consumer products, such as soap or shampoo.

In addition, some businesses prosper while others fail. When a business fails, stockholders--and sometimes bondholders--can lose their entire investment.

Financial, credit, or default risk

Financial or credit risk arises when a company incurs excessive debt. Put in accounting terms, financial risk is related to the company's debt-to-equity ratio. That means the company has a high fixed obligation (interest) to pay each year. If the firm does not perform well, it may be unable to satisfy that obligation and pay bondholders or preferred stockholders. In addition, borrowing exposes the company to the risk that creditors will file legal claims against it.

Liquidity risk

Liquidity risk refers to the chance that an asset may not be easily sold, or may not receive its full market value, especially if it must be sold on short notice. For example, if a company's stock is held by relatively few stockholders and demand for the shares is not high, one of those stockholders might have difficulty finding a buyer, which could affect the stock's price.