Risk Management: A Strategic Approach

"November is a particularly risky month in stocks…so is April, June, September, January, May, December, February, March, October, July, and August."

--Mark Twain

Undoubtedly, these are risky and trying times for all. But for the investor, as Mark Twain well knew, it has always been so.

Yet, a solid understanding of the inherent risk in any given portfolio is a good way to prevent nasty surprises in the future.

Sophisticated investors know that all investments carry some level of risk. Risk management is the ability to recognize various types of risk and control their impact on a portfolio.

There are four primary types of investment risk.

Performance Risk is what most people commonly and often associate with investing. Buy a stock or other security and it will either gain or lose value. Most everyone would prefer a gain to a loss, but losses are nonetheless inevitable. The aim of investment management is to minimize the risk of loss, typically through the selection of diversified investments.

A well-planned diversification strategy can ensure that no particular security or class of securities will jeopardize overall portfolio performance. Holding an all technology or an all electric-utility portfolio is one example of a portfolio holding excessive risk through a lack of diversification – in other words, having all one's eggs in too few baskets.

Market Fluctuations can cause additional risk. Fortunately, many markets behave somewhat independently of each other, and tend to gain or lose value concurrently. So when the stock market heads south for example, as it has for nearly two years now, bonds in most instances will have held or gained in value.

So here again diversification, this time among asset classes such as stocks, bonds and cash, is the best hedge against the risk of market fluctuations.

An experienced investment manager can establish the best diversification strategy for any particular investor based on may factors unique to the individual, such as age, overall goals, liquidity needs and time frame.

Inflation poses yet another type of risk. As your investments gain or lose value in their individual markets, the dollar also gains or loses purchasing power. Hence, the rate of inflation can decrease the value of your portfolio. In fact, a portfolio that may appear to be appreciating modestly from one year to the next may indeed be losing value due to the corrosive effects of inflation.

Your investment strategy therefore must weigh the risk of inflation against the risks of individual investments that may have rates of return higher than inflation.

Finally, the price of fixed-rate securities, such as taxable and tax-free bonds, can expose your portfolio to the fourth type of risk - **Interest Rates.**

As interest rates fall, the prices of fixed-rate securities generally rise. For example, an older bond, with a higher paying coupon, or interest rate, will generally be worth more to a buyer than a newer bond with a lower coupon. Conversely, the prices of fixed-rate securities usually fall as interest rates rise. A new bond with a higher paying coupon will command more buying power than an older bond with a lower coupon – the older bond having lost pricing power, or value.

Your investment management strategy can balance interest rate risk by adjusting the term of the fixed-rate securities you hold in your portfolio. For example, a short-term bond, one that is due to repay principal to the bondholder in the near-term, will fluctuate in price less drastically than one that matures further out in the future.

Of course, the greatest risk any investor can take is choosing not to be informed. Continue to learn, read, and ask questions. Along with a sound investment strategy this is an investor's best defense against undue losses.

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