Don't waste your risk

Look for the highest return for a given level of risk… or the lowest risk for a given level of return

In the investment world, the term "investment risk" relates to the fluctuations in the value of a stock, bond or a mutual fund that invests in those assets. The phrase "don't waste your risk" refers to avoiding excessive investment risk. It stems from the rationale that investors feel a great deal more displeasure when the value of their investment declines, than the pleasure they experience when their investment increases. Therefore, it stands to reason if investors are going to invest in risky assets such as stocks and bonds they would prefer to do so in such a way that the potential rewards outweigh the potential risks.

Achieving your investment goals requires patience and a keen understanding of how you would like to achieve those goals. Designing your investment portfolio should not only consider the rate of return you wish to achieve but also the investment risk you may encounter. Generally, the desire for a specific investment return should be secondary. The primary focus should be on identifying your comfort level with risk and then, through proper analysis, determine an appropriate mix of assets that will potentially provide the highest return that corresponds to the desired amount of risk you are willing to withstand.

The objective to reduce investment risk is critical, as it is far easier to lose money than it is to earn it. What is often overlooked is that it takes a greater effort to recover a loss than it did to incur that loss in the first place. Consider an investment of $10,000 that incurs a one-year loss of 15%. At year-end, the investment is now worth $8,500. Because you are now working with less capital, in order to recover the investment loss and get back to your original investment amount, you must now achieve a return of 17.65%. Market declines have been known to be even more extreme which places an even greater emphasis on obtaining higher returns to recover investment losses. Proper care must be taken to avoid excessive market volatility and insulate yourself as much as possible from such occurrences.

The easiest way to reduce risk is by investing in assets that offer a guaranteed rate of return. The problem is that the investment return of a guaranteed investment is relatively low. This means that over time the effects of inflation will likely ravage the value of the investment. Quite often investing in risky assets such as stocks and bonds tends to be the most appropriate means for achieving an investment goal. To that end, the best way to invest in stocks and bonds without incurring an excessive amount of risk is by diversifying your assets.

Proper diversification and asset allocation is essential, as it will reduce risk without sacrificing a whole lot of return. Investing always involves an element of risk, and no matter how careful an investor is, losses will occasionally occur. That is why an appropriate investment strategy must be in place to help minimize risk. One of the most widely accepted strategies is "strategic asset alloction".

Strategic asset allocation is a long-term process used to identify the percentages of an investment portfolio that will be invested in a variety of investment securities. These percentages will vary between portfolios that have different goals and objectives. For example, a portfolio being managed to create an education fund fifteen years from now would normally have a much larger equity allocation than one designed to produce retirement income right now. While these two objectives may differ, the goal of strategic asset allocation remains the same. Namely, to develop a portfolio that potentially offers the highest return for a given level of risk, or conversely a portfolio that is expected to produce the lowest risk for a given level of return.

Getting to the right asset mix can be complex. Quite often, computer models are utilized to produce a mathematical framework that effectively analyzes the investment returns and risk characteristics of a large number of

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asset classes such as U.S., International or Canadian equities, along with bonds and real estate. Depending on the number of asset classes included in the analysis, the computer model may literally analyze thousands of different asset combinations. In view of most investors' busy schedules, they have neither the time, patience or skill to undertake such an analysis which is why they normally turn to an investment professional.

Depending on your objectives and preferences, a portfolio may contain anywhere from six to ten distinct asset classes ranging from fixed income securities to domestic to international equities and further diversified by growth and value management styles.

The end result is an investment strategy that is tailored to your comfort level with risk. Risk-averse investors typically invest in a portfolio that emphasizes fixed-income securities. The goal is usually related to capital preservation and income generation. As the appetite for a potentially higher return increases, so does the corresponding investment risk. That is because obtaining a higher return usually involves a greater emphasis on equity type investments that are characteristically more volatile in terms of price fluctuation. For the more aggressive investor, a portion of their equity investments may focus on emerging markets or a particular industrial sector.

Through a strategic asset allocation approach, it is possible to combine a series of fixed-income securities and equities together in a portfolio that will exhibit less volatility than most of the individual constituents — provided every security included complements the diversity of the portfolio's content. Using this approach and resisting the temptation to "time" the market by temporarily concentrating holdings in any one area will not completely remove the risk of financial loss, but it can help you to build personal wealth without taking undue risk.

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