Learn the 4 Primary Types of Risk and Make Wiser Investment Decisions

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Evaluating risk accurately is an important skill. ***All investments carry some level of risk.*** It is true that some investments, such as US Savings Bonds, have practically zero risk. Bonds issued by companies in great financial distress carry much more risk.

Many investments are priced based on the perceived level of risk. Many of the world's wealthiest investors are able to determine risk more accurately than the market. They are able to acquire higher returns at a lower level of risk.

Enhance your investing knowledge by understanding risk:

1. **Default Risk.**The risk of default is determined by the quality of the entity that underlies the investment. If you purchase a stock, how sound is the company? Purchasing bonds offered by a foreign government can be very safe or very risky, depending on the stability of the government and that country's economy.
    - This explains why junk bonds offer a better return than higher-grade bonds. The risk of default is considerably higher. Investors want a better return in exchange for greater default risk.
    - Treasury Bills are very low risk, and therefore, pay a low interest rate. Unfortunately, the safest investments will rarely outpace inflation.
    - ***It's important to focus on the strength and stability of the underlying investment.***

2. **Market Risk.** This type of risk is independent of the underlying investment. Market risk can affect an individual stock or bond, but the impact is similar across the market. This type of risk is often referred to as systematic risk.
    - Equity risk, interest rate risk, and currency risk are specific types of market risk.
    - Foreign investments can be especially susceptible to currency risk. The company might do well, but if the exchange rate becomes unfavorable, you could still lose money. This can be true even if the stock price increases.
    - ***High interest rates and political instability are examples of conditions that affect the entire market.***
3. **Inflationary Risk.** Inflation will eat away at your returns. You might buy and sell a stock and earn 10%, but if inflation was 6% over the same period, your true return is only 4%. Your ability to purchase items decreases with inflation.
    - ***There are ways to combat inflation. One option is investing in items that tend to increase with inflation, such as precious metals.***
    - Inflation risk is also referred to purchasing power risk.
    - There are bonds that provide a guaranteed return above and beyond inflation. These bonds are called TIPS, or Treasury Inflation-Protected Securities.
4. **Mortality Risk.** Many investments continue to pay you only while you're still alive. Pension plans and annuities are two examples. There's no guarantee that you'll live long enough to receive enough payments to make your investment

worthwhile.

- There's another type of mortality risk. You could outlive your finances. Unless you live below your means, it's possible that your retirement accounts and other investments could run dry while you're still alive.

- Avoid assuming that you'll have an average lifespan. Living significantly shorter or longer than you expect can create financial challenges. Maintain a healthy balance of long-term and short-term investments.

Do you consider risk when making investment decisions? ***The expected return of any investment is a function of the predicted risk involved.*** Higher risk investments have the potential to provide greater returns. Determine if the returns you expect are worth the risk involved.

Understanding risk is a key component of investing. If you can assess risk more accurately than the marketplace, you'll be extremely successful.