Investment Planning

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Investment Planning "The Risk – Return Trade-off"

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Do you have too little or too much risk in your investment portfolio? Risk is not be feared but rather, it needs to be understood and managed. Too much risk can offset potential investment gains. Too little risk reduces an investment portfolio's ability to achieve those gains.

To put investment risk into context, here are but three examples of risk to consider:

Interest rate risk refers to the chance or probability that a change in interest rates may leave an investor with either: a lower rate of return on a specific investment that is available on other investments or a lower return than had been anticipated when the investment was first purchased. Fixed rate investments like term deposits and GICs, lock in a set interest rate for a defined period of time. In these cases, the investor is protected against rates going lower. However the flip side is when rates go up, the investor is stuck with the lower fixed interest income rate. A "laddered" approach that staggers the maturity dates of multiple term investments can help soften the impact. Alternatively, a mutual fund that holds multiple bonds with multiple maturity dates is an easy way to help overcome this risk.

Inflation risk is the likelihood that increases in prices will erode the purchasing power gain of an investment. Inflation is the increase in the general price level. If the inflation rate is 5% a year, then a basket of goods which cost $100 in one year will cost $105 the next year. You will need $105 to purchase the same things in the second year and so on. To meet long term financial goals, an overly conservative portfolio may benefit from diversification with equities for added growth potential.

Market risk is the potential to lose money due to the fluctuating nature of investment markets. Fear of market risk is usually greater that the actual danger, especially for investors with the time to wait out market cycles. Good planning can build the confidence needed to remain patient during downturns. Your financial advisor can help you align your risk tolerance with your long term goals, and diversify your portfolio among asset classes, sectors and regions.

To summarize, it's all about taking control! Achieving a desired rate of return is a function of balancing your risk tolerance against your investment objectives which include: safety of principal, liquidity, income and capital growth.

Risk can be minimized by choosing various investments of different risks in the same investment portfolio. This spreading of risk across investments is called diversification. With markets improving, there has never been a better time to review the level of risk exposure in your investment plan.

Want to learn more about investment planning? Visit us at www.allainassociates.com and click on Investment Planning.

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