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Types of Investment Risk

People save and invest their money to receive a return on their savings or investment. In this exercise, we will call any type of saving or investing an "investment." The return is the income earned from the investment; it is usually calculated on a yearly or annual basis. That return can be stated as a percentage of the amount invested. Then it is called the annual rate of return.

Risk comes from the uncertainty about whether you will receive the promised return. The greater the risk you take with your investment, the higher the potential rate of return. Unfortunately, with more risk, it is also more likely that you will lose money. In other words, you can expect a return from taking risks with your money, but you could also take a financial loss. As with any economic decision, there is no free lunch in deciding about investments. Here are some of the risks you take when you invest your money.

Financial Risk

Financial risk is the risk that the business or government that you have invested in will not be able to return your money—much less pay a rate of return. Businesses, state agencies, and local governments have declared bankruptcy on some past occasions. The U.S. government is unlikely to become bankrupt, so investing in U.S. government savings bonds carries very little financial risk. Insured accounts in banks, savings and loan associations, and credit unions are insured by the Federal Deposit Insurance Corporation (FDIC) up to $250,000, so they carry no financial risk.

Market Risk

Market risk is the risk that the price of an investment will go down. This doesn't usually happen to money saved at a bank, savings and loan association, or credit union. However, the prices of stocks, bonds, and mutual funds are determined by supply and demand, and they do go down (as well as up). The **supply** of an investment refers to the different quantities of that investment that will be offered for sale at various prices during a specific time period. The **demand** for an investment refers to the different quantities of an investment that investors are willing and able to purchase at various prices during a specific time period. The equilibrium price is the price at which buyers want to buy the same amount of an investment that sellers want to sell. The important point is that anything that changes the behavior of buyers and sellers can change the price of an investment. For example, technology stocks have been "hot" at various times. Prices increased because more people wanted technology stocks at various price levels (demand increased). When investors became less interested in technology stocks, the average price fell because fewer people wanted technology stocks at every price level (demand decreased). Investors' expectations of the future earnings of companies play a large role in the value of stocks. When company earnings fall below what investors have expected, it is common for the stock price to fall. In recent years, there have been occasions

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in which "bubbles" seem to have appeared in the stock market. These bubbles represent stocks whose value is overly inflated relative to companies' fundamental value. It is difficult to know for sure when a bubble appears, but when a bubble does appear there is significant market risk that the bubble will burst, causing a decline in stock prices.

Liquidity Risk

Liquidity is the ability to turn your money into cash or spendable funds. Checking accounts, for example, offer high liquidity. Some investments are very liquid. Savings accounts generally allow you to withdraw your money at any time without a penalty. Stocks listed on a stock exchange are very liquid; you can buy or sell them at any time (although you may have to take a less favorable price). Real estate and collectibles, on the other hand, are not very liquid because it takes time for a seller to find a buyer. Although the Internet is speeding up this process, there is no guarantee that a buyer and seller can get together on price and other terms for the sale of real estate and collectibles.

Inflation Risk

People invest money today in order to have that money, and more, available to spend in the future. The goal is to receive the original investment back plus a return, so that you will be able to buy more in the future. Inflation can decrease the value of your investment. When you save or invest, you are deferring your spending until a later time. If prices rise over that time, your money will not go as far as it would have gone earlier. Therefore, investors are more interested in the real rate of return than the nominal rate of return. The **real rate of return** is the **nominal rate of return minus the inflation rate.** For example, let's say you put your money in a certificate of deposit at a 5 percent rate of return. The annual rate of inflation is 3 percent. Therefore, your real rate of return is 2 percent (5 percent – 3 percent = 2 percent). In general, the longer the time period, the greater the likelihood that purchasing power will decrease because of inflation, and the greater the inflation risk.

Fraud Risk

Some investments are misrepresented. In these cases, information about the investment is designed to deceive investors. Anyone can print a fancy brochure, make promises on the telephone, or guarantee great returns on the Internet. Criminals often make up facts that turn out to not be true. Therefore, it is important to investigate before you invest. Most investment fraud occurs in securities and savings schemes that do not involve banks, savings and loan associations, credit unions, and brokerage firms.

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Questions:

a. What is the annual rate of return on an investment?

b. If you earn $40 a year on a $500 investment, what is the annual rate of return?

c. What is the relationship between the expected rate of return and the investment risk?

d. If the annual nominal rate of return on an investment is 10 percent and the annual rate of inflation is 3 percent, what is the real rate of return?

e. True, false, or uncertain, and why? "The Internet is the future of our economy. The prices of Internet stocks are bound to go up."

f. True, false, or uncertain, and why? "This investment pays 30 percent a year and is perfectly safe. I put my mother's money into this investment."

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The Pyramid of Risk and Rewards

The figure above ranks investments according to their risks and rewards. The higher an investment is on the pyramid, the greater the risk. Because the risk is greater, the potential rewards and potential losses are also greater.

Your job is to rank each of the investments on the following pages on a 1-3 scale, with 1 representing the lowest risk or reward and 3 representing the greatest risk or reward. Circle the number that best represents each risk or reward. For each choice, explain your answer.

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Mattress

You could hide your money under a mattress.

Financial Risk	1	2	3	**Why?**
Market Risk	1	2	3	
Liquidity Risk	1	2	3	
Inflation Risk	1	2	3	
Reward	1	2	3	

Regular (Passbook) Savings Account

The Federal Deposit Insurance Corporation (FDIC) insures savings accounts for up to $250,000. Interest rates on these accounts are usually lower than rates for other savings and investment choices, but you can open an account with very little money and you can withdraw your money whenever you like.

Financial Risk	1	2	3	**Why?**
Market Risk	1	2	3	
Liquidity Risk	1	2	3	
Inflation Risk	1	2	3	
Reward	1	2	3	

Certificate of Deposit (CD)

CDs are a special type of savings deposit that you must leave in the bank for a set amount of time, during which you receive a fixed rate of interest. The FDIC also insures these accounts for up to $250,000. Banks usually require that you deposit at least $500 in a CD. If you withdraw your money before the end of the agreed-upon time, you must pay a penalty—usually in the form of forgone interest earnings.

Financial Risk	1	2	3	**Why?**
Market Risk	1	2	3	
Liquidity Risk	1	2	3	
Inflation Risk	1	2	3	
Reward	1	2	3	

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Money Market Mutual Funds

These funds are sold by investment companies that pool investors' funds and use the funds to purchase very safe and very liquid short-term financial products offered by businesses and governments. For every dollar put in such a fund, an investor can expect to get back a dollar plus interest. Although money market mutual funds are not insured by the federal government, they are low-risk investments. Interest rates are usually higher than rates on bank accounts but lower than returns for stocks and bonds bought and held for the long term. Investors can get their money out of a money market mutual fund at any time. Some funds also allow investors to write checks on their accounts.

Financial Risk	1	2	3	**Why?**
Market Risk	1	2	3	
Liquidity Risk	1	2	3	
Inflation Risk	1	2	3	
Reward	1	2	3	

Stocks

Stocks are shares of ownership in a corporation. When you buy stock, you take the risk that the value of the company might decline. Such a decline would reduce the value of your ownership stake. Some stocks make quarterly payments to investors, which are called dividends. Your return for stock ownership will vary, depending on what happens to the prices of the shares and the dividends received. Stocks on exchanges such as the New York Stock Exchange and NASDAQ can be bought and sold whenever the exchange is open. The amount of money you need to buy stock depends on the prices of the stocks you want to buy and the number of shares you want.

Financial Risk	1	2	3	**Why?**
Market Risk	1	2	3	
Liquidity Risk	1	2	3	
Inflation Risk	1	2	3	
Reward	1	2	3	

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U.S. Government Savings Bonds

You can buy savings bonds from the federal government for as little as $25. You can't sell these bonds to other people, but the government will redeem them after they have been held for a minimum amount of time. If you need to sell them before maturity, there may be a penalty in the form of loss of interest.

Financial Risk	1	2	3	**Why?**
Market Risk	1	2	3	
Liquidity Risk	1	2	3	
Inflation Risk	1	2	3	
Reward	1	2	3	

Stock Mutual Funds

Stock mutual funds are offered by investment companies that pool funds from individual investors to purchase stocks. The risk depends on the investment objective. Some funds invest in high quality, blue-chip stocks; others invest in more speculative stocks. The major difference in buying a fund rather than individual stocks is that you indirectly own many stocks in a mutual fund, and you don't have all your eggs in one basket. Therefore, the risk is lower than the risk that comes with owning an individual stock. You can sell your shares in the fund back to the fund company at any time.

Financial Risk	1	2	3	**Why?**
Market Risk	1	2	3	
Liquidity Risk	1	2	3	
Inflation Risk	1	2	3	
Reward	1	2	3	

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Stock Index Funds

Stock index funds are mutual funds that invest in groups of stocks that mirror segments of the stock market. For example, an S&P 500 index fund would invest in the companies in the S&P 500 index—primarily large-cap U.S. stocks. Index funds require no selection or decisions by fund managers, so they have lower fees than other mutual funds. Index funds outperform managed funds most of the time. Index funds provide diversity and high performance with relatively low fees. They are a great choice for individual investors.

Financial Risk	1	2	3	**Why?**
Market Risk	1	2	3	
Liquidity Risk	1	2	3	
Inflation Risk	1	2	3	
Reward	1	2	3	

Real Estate

Most investors in real estate buy the house they live in. Houses can increase in value, but housing prices can also fall. Sometimes when prices do rise, they rise less than the inflation rate. To sell your house, you must find a buyer. Many buyers and sellers use real estate brokers.

Financial Risk	1	2	3	**Why?**
Market Risk	1	2	3	
Liquidity Risk	1	2	3	
Inflation Risk	1	2	3	
Reward	1	2	3	

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