How to evaluate the risk of an investment

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Risk is all around us, and we all take risks every day. Some people consider driving a car risky. Others don't seem to mind driving but don't like flying in an airplane – even though statistics show you're far more likely to die in a car than in an airplane. Some of us, like race car drivers, cliff divers, and bungee jumpers, actually thrive on risk. Others go to great lengths to reduce risk.

Risk is multidimensional with many factors interacting. For example, an athlete in top physical condition may suffer a fatal heart attack while exercising because he or she has a family history of heart disease.

Some risks are more apparent than others. For instance, walking a high wire is quite obviously a risk. On the other hand, the danger of being struck by lightning is not so obvious.

The bottom line is that you can't live without taking some risks. Since you cannot totally eliminate them, the best you can do is try to reduce them as much as possible. That's why we avoid people with colds, eat healthy diets, wear life jackets when we go boating, and buy life insurance.

Some people view risk as a negative, others as a positive. Ask any group of people what risk means to them, and you are likely to get some of these answers:

- Danger
- Possible loss
- Uncertainty
- Challenge
- Opportunity
- Thrill

In the investment world, however, risk means uncertainty. It refers to the possibility that you will lose your investment, or that an investment will yield less than its anticipated return. More simply stated, risk refers to the probability that an investment will make or lose money. Every investment carries some degree of risk because its returns are unpredictable. The degree of risk associated with a particular investment is known as its volatility.

When you invest, you plan to make money on that investment or, more accurately, earn a return. Risk and return are directly related: the higher the risk, the higher the return potential. If you want a higher rate of return, you will have to accept a higher risk. Conversely, you may accept a lower risk, but the return potential is lower. As a technical note, the term "risk-return tradeoff" refers to the universal principle that investors should plan to be compensated for taking higher levels of risk of loss by earning higher rates of return.

The length of time that you plan to remain in a particular investment vehicle is known as your investment planning time horizon. Generally speaking, the longer your time horizon, the more you can afford to invest more aggressively, in higher-risk investments. This is because the longer you can remain invested, the more time you'll have to ride out fluctuations in the hope of getting a greater reward in the future. Of course, there is no assurance that any investment will not lose money.

Each of us is able to accept a certain amount of investment risk. This is known as our risk-taking propensity. Those of us who can accept a relatively great amount of risk are referred to as risk tolerant. On the other end of the spectrum, those who can accept very little risk are known as risk averse. Those who hold the middle ground are risk neutral or risk indifferent.

There are ways to measure your risk tolerance, using tests to assess how you react to different types of risk, such as monetary, physical, social and ethical. These tests aren't foolproof, since we are essentially talking about psychological behaviors that may vary under different conditions. However, the results from these tests are generally considered reliable and valid. Your risk-taking propensity is as important in determining which investments match your risk/return expectations as the risk of the investment itself.

Before you can evaluate the risk of a specific investment, you must understand the types of risk that exist and how to measure them. As in your day-to-day life, risks are prevalent in the investment world, and some are more apparent than others. Each investment is subject to all of the general uncertainties associated with that type of investment. These are known as systematic risks and include market, interest rate and purchasing power risk, among others. Risk also arises from factors and circumstances that are specific to a particular company, industry or class of investments. These are known as diversifiable or unsystematic risks. Diversifiable risks include business, financial and default risk, among others.

Measuring risk involves analyzing the different types of risk using an array of mathematical tools and techniques (e.g., the standard deviation, Beta, Alpha, and so forth). The statistics obtained provide an investor with some standardized measurements with which to make an educated decision.

You don't need to measure risk yourself. Ratings services, such as Standard & Poor's, Fitch, Moody's, Value Line, and Morningstar, compile and publish risk and return statistics for many types of investments. These services provide an investor with key information and statistics in a condensed and easy-to-read format. To obtain rating service reports, check with your public library. It may subscribe to some or all of these services. If not, you may have to subscribe yourself, for an annual fee. Some services offer a free trial period.

For specific investments, you may be able to view an annual report, prospectus, or proxy statement with financial information and outlined business strategies. To obtain copies of these documents, contact the issuer of the security. You may find helpful information in books, newspapers, magazines, journals, newsletters, or on the radio, television or internet.

One of the best ways to reduce risk is to develop a portfolio of investments that is balanced in terms of the types of assets in which you invest. In other words, don’t put all your eggs in one basket. This is known as diversification or asset allocation. A portfolio that mixes a variety of asset classes (e.g., cash, bonds, domestic and foreign stocks, and real estate) has a lower risk for a given level of return than does a portfolio that consists of only one. Diversification works because it broadens your investment base. An investor can achieve diversification by investing in different types of companies, industries, securities, markets, or by having various investment objectives. How an investor diversifies depends upon his or her own situation. An investor can be aggressive (investing mostly in high-risk vehicles), conservative (investing mostly in low-risk vehicles), or somewhere in between. (Diversification does not ensure a profit or protect against a loss in a declining market.)

Historically, time has had a dampening effect on the riskiness of investments (though there is no guarantee this will continue in the future). In "investmentspeak," the standard deviation associated with the average rate of return on an investment has decreased with the square root of time. In plain English, the longer the investor remained invested – or the longer the investor’s time horizon – the less risky the investment has become.

You may be able to reduce some risk simply by being diligent. For example, have real estate inspected and appraised before you buy it, or investigate a company’s financial condition before you purchase stock in it.

Gauge the economy by identifying trends in overall business conditions. These trends are indicated regularly (weekly or monthly) by figures on inventories, prices, employment and the GDP. Is the economy on an upswing or downswing? Knowing this will help you choose an investment more likely to appreciate under the given conditions.

Choose investments that make sense to you. For example, buy stock in a company with relatively stable earnings, or one whose sales are likely to keep up with inflation, or one whose products are in great demand, or one who sells a product for which the demand is constant, such as food.

Cameron Short,CIMA, is a Senior Vice President/Investments with the Pittsburgh office of Stifel, Nicolaus & Company, Incorporated