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No Shortage of Investment Risks

You can't escape it -- every investment has risk. But there are many types of risk, and each type affects investments in a different way. While you'll generally have to accept some risk to reach your goals, understanding and evaluating the various kinds can help you make better investment decisions. Below are some of the more common types of risk investors encounter.

Market Risk

Market risk is the possibility that your investments will lose value because of factors that affect the broad economy and the securities markets. It is often the risk investors think of first. Long-term investors can generally ride out periods of stock market volatility since, historically, the market has always recovered its losses over time.[1] Because gains in one asset class may help offset losses in another, dividing your investments among stocks, bonds, and cash may help you manage market risk.

Inflation Risk

Over time, the rise in the cost of goods and services can seriously reduce the buying power of your money, even when inflation seems low. Putting your long-term investment dollars primarily into fixed-income investments can leave you at risk of not earning enough on your investments to reach your goals. Investing at least some of your money in investments with the potential for earning higher returns, such as stocks, can help reduce inflation risk.

Interest Rate Risk

Changes in interest rates affect bond prices. When interest rates rise, prices of existing bonds fall because older bonds are paying less interest than newly issued bonds. On the other hand, when interest rates fall, bond prices and values typically increase. You can help reduce interest rate risk by holding a variety of bonds having different maturity dates, a strategy known as "laddering."

Default Risk

If a bond issuer doesn't have money to make principal payments to bondholders, you could lose your entire investment. Default risk is generally more of a concern to investors who buy lower-rated bonds. Checking an issuer's credit rating with a bond-rating service, such as Moody's or Standard & Poor's, and choosing bonds rated "investment grade" by the rating agency can help minimize default risk.

Currency/Geopolitical Risk

Adding international investments can help diversify your portfolio.[2] But investors should use caution. Currency exchange rates, foreign taxation issues, differences in auditing and financial standards, and political instability, especially in emerging markets, can adversely affect the value of foreign investments.

[1]Past performance is no guarantee of future results.
[2]Diversification does not ensure a profit or protect against loss.

Goals for Now, Goals for Later

Investing would be a lot easier if you had only one thing to save for. But from your first house to your retirement, you'll have different financial goals at different life stages. Your financial plan should help you meet your objectives at each stage of your life.

In the Near Term

When you're starting out, you may be more focused on saving for things you want in the near future -- a new car or a house, for example. Your paycheck may not stretch very far, but having a spending plan can help. Once you've identified your goals, saving even a small amount from each paycheck can help you reach them.

In the Middle

You may have multiple goals that you're saving for down the road: maybe a larger house and your kids' college expenses. But don't forget about retirement. You'll likely need more savings for retirement than for any other goal you have.

The middle years are important for asset growth, so consider keeping a significant portion of your portfolio invested in securities, such as stocks, with the potential for earning higher returns. Although there are no guarantees, historically, stocks have outperformed other asset classes over the long term.[1]

In the Future

Your most important long-term goal is retirement. If you save and invest throughout your working years, you may be able to accumulate significant assets. Shifting a portion of your portfolio into lower risk investments as you near retirement may help you preserve your gains. You might also consider leaving some money invested in stocks can help cushion your savings from the effects of inflation. Even after you retire, holding some stock investments in your portfolio may be a good strategy.

Your situation is unique, so be sure to consult a professional before taking action.

[1]Stock investing involves a high degree of risk. Stock prices fluctuate and investors may lose money.