Investing 104

Managing Risks

What type of risks exist when investing?

- There are several types of investment risks that we will cover in this course. These risks are present at varying levels on each stock in the market. Fortunately, there is a way to protect yourself against risk. These techniques should always be considered and included in your overall investment strategy.
    - **Liquidity Risk**
    - **Market Risk**
    - **Economic Risk**
    - **Specific Risk**
    - **Forecast Risk**
    - **Fashion (“Meme”) Risk**
    - **Timing Risk**
    - **Time Risk**

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Liquidity Risk

- Time horizon and liquidity of investments is often a key factor influencing risk assessment and risk management. Liquidity risk refers to the risk that you won't be able to buy or sell stocks when you want because there is little or no demand for it.
- You can lessen this risk by choosing investments that are traded on an active market and investing using funds that are not required for your current expenses.

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Market Risk

- Market risk is the possibility that some big picture, external circumstance will negatively affect the financial markets as a whole. This doesn’t relate to the individual investment but to the stock market as a whole.
- For example, the stock market may drop as a result of the Federal Reserve suggesting that interest may be raised.
- One way to deal with market risk is to diversify your investments over various asset categories such as stocks, bonds, cash, real estate and other categories. Holding assets from different categories reduces the possibility that all investments will be down at the same time.

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Economic Risk

- This is the danger that a downturn in the economy or other significant economic event will depress the value of your investments by reducing earning capabilities. An easy example of a recent economic risk is the global shutdown of the economy due to the COVID-19 pandemic.
- Diversification over broad categories and even foreign investments that do not work in conjunction with each other can help prevent this risk.

Specific Risk

- This relates directly to the individual stock or investment itself. New technology can be introduced that makes the company's products obsolete or greater competition can reduce their earning capabilities. There are several specific risks that each individual investment has.
- You can lessen this risk by diversifying your portfolio or even investing in mutual funds and index funds. The specific risk is spread out over a larger number of companies by using diversification.

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Forecast Risk

- Often times a stock rises because of anticipated earnings reports or other good news. If the company fails to meet the forecasted earnings, the stock may drop even to a lower level than where it started. However, stocks can also drop when the forecast is only just met because the anticipation is that the estimate will be ***exceeded.***
- Diversification is a solution to lessen this risk.

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Fashion or ‘Meme’ Risk

- When choosing investments, try not to be swayed by what happens to be trending at that moment. Things go in and out of style and investments are no different. You are likely to have better and more consistent success by choosing companies that have established solid reputations. If you put a disproportionate portion of your assets in a particular sector, you will be overexposed if that sector goes out of fashion.
- As with many other types of risk, diversification is the way to mitigate the effects of this risk.

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Timing Risk

- You can never time the market exactly. You could be completely correct about an investment but act too early. Whereas acting too late would not be a timing risk but a mistake.
- Market timing is not an effective strategy. You can help lessen this risk by developing a plan, such as dollar cost averaging (DCA), that will be implemented over a period of time and sticking to it.

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Time Risk

- This is different than the timing risk we just discussed. The time risk occurs if your needs change and you need to liquidate (sell) an investment earlier than anticipated. You will have to take what the current market price is offering which may be considerably less than if you waited the length of time you originally planned to hold the investment.
- You can protect yourself against time risk by having a good thought out investing strategy that takes into account the possibility of changes to your liquidity situation.

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Next Steps

1) Review your current portfolio and evaluate the risks you have present.
2) Look to implement some of the techniques to help lessen your risk.
3) Consider diversifying your portfolio.

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