Types of Investment Risk

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

***Risk* is the uncertainty that you will receive the promised return. The greater the risk you take with your investment, the higher the potential rate of return and the greater the chance that you might not receive that return. In other words, you are paid for the risk you take with your money. 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 will not be able to return your money —much less pay a rate of return. Businesses, state agencies, and local governments have on some occasions declared bankruptcy. The U.S. government prints money, so there is no financial risk that it will not pay off its bonds. Insured savings accounts are insured up to $250,000 by an agency of the federal government, so they carry very little financial risk.

MARKET PRICE RISK

This is the risk that the price of an investment will go down. This rarely happens to money saved in a bank, savings and loan, 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 is 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 will be purchased 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).

LIQUIDITY RISK

Liquidity is the ability to turn your money into cash or spendable funds, such as a checking account. Some investments are very liquid. For example, some savings accounts 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. 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 real estate and collectibles.

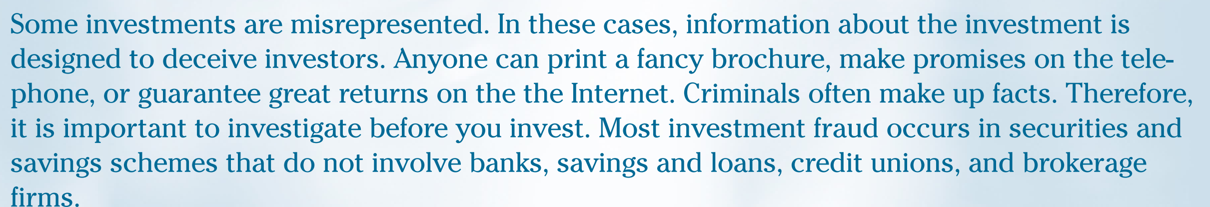
INFLATION RISK

Money is invested today in order to spend it tomorrow. 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. 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 an 8 percent rate of return. The annual rate of inflation is 3 percent. Therefore, your real rate of return is 5% (8% - 3% = 5%). The longer the time period, 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 the Internet. Criminals often make up facts. 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 loans, credit unions, and brokerage firms.



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

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

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

4. 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?

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

6. 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."