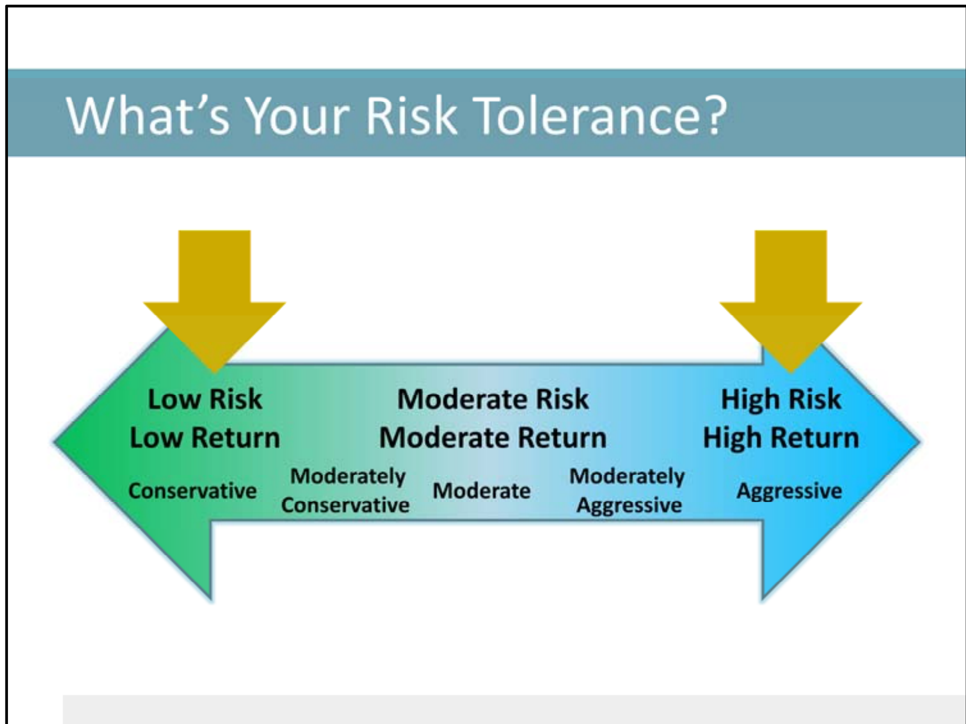
Imagine you're the guy in this picture. Do you think what he's doing looks like fun, or does it make you feel nervous? Would you feel more secure if you were wearing some pads, or at least a helmet to protect that priceless head of yours?

We're all different when it comes to risks. You might think that putting a helmet on wouldn't make flying through the air on a skateboard any less fun, while someone else might feel like the thrill comes from the danger of not wearing any protection.

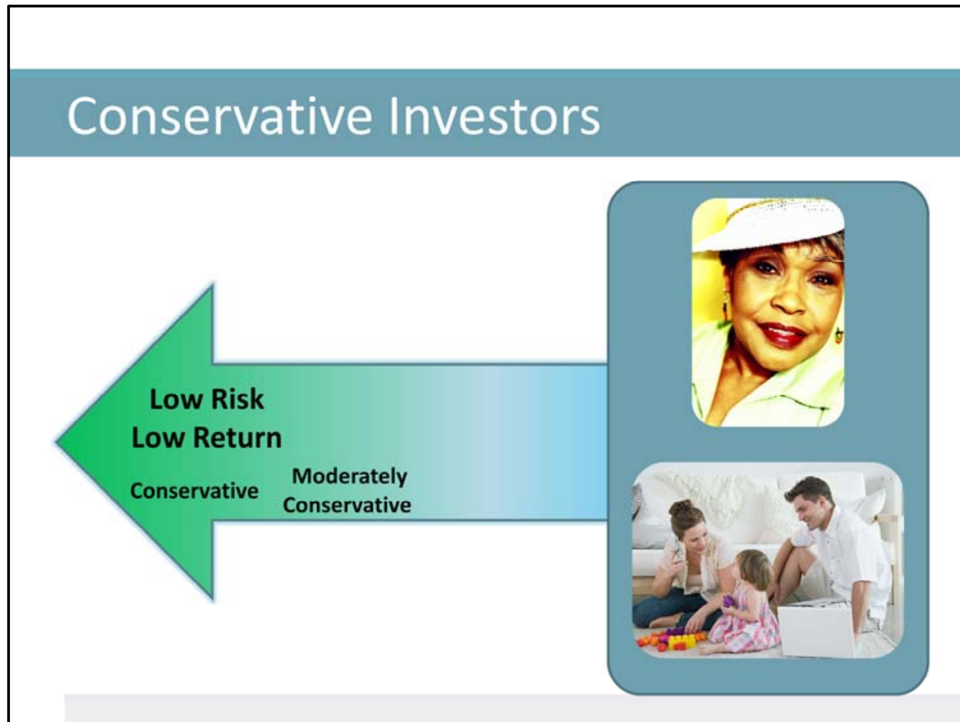
When it comes to investing, risks and rewards are much more easily defined. Risk is the uncertainty of what your rate of return on an investment will be, and reward is what you get when that risk pays off. The higher the risk, usually the higher the potential reward, but also the higher the possibility that you might actually lose some or all of the money you invested.



Your personality, especially with regards to risk, has a big influence on how you invest your money. Understanding your risk tolerance is key in developing your own personal investment philosophy or strategy. Investors generally fall into one of three categories: conservative, moderate and aggressive.

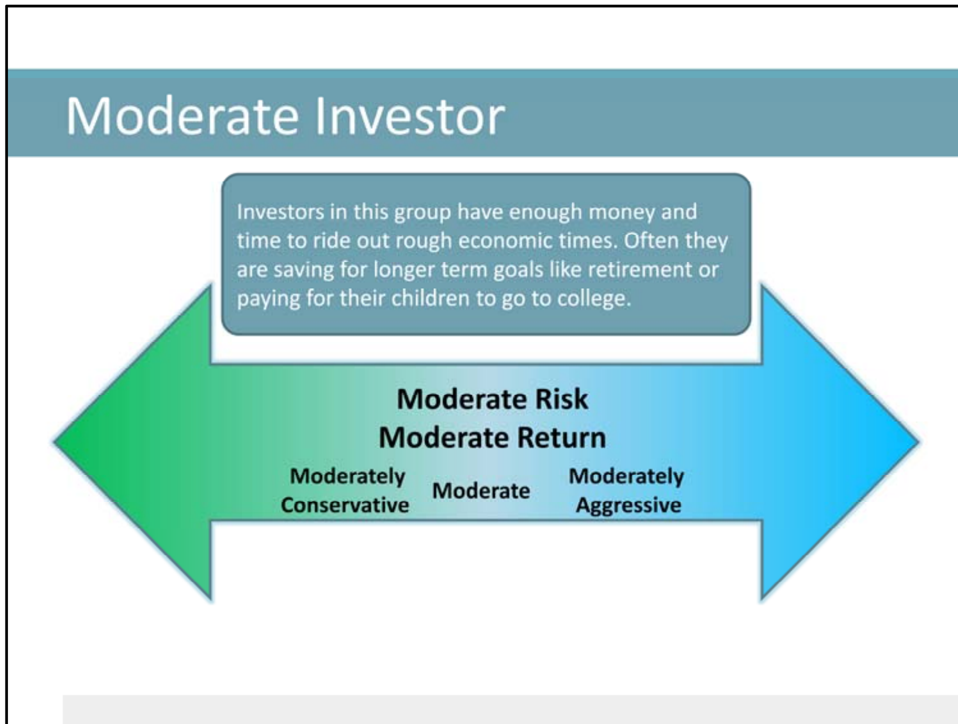
Conservative investors tend to fall towards the left side of the diagram and have most of their investments in low risk, and therefore, usually lower return investments. Aggressive investors fall towards the right side and have mostly high risk/high return investments that have a higher possibility of losing money. Moderate investors fall somewhere in the middle.

Regardless of your risk comfort level, almost everyone has investments across the risk spectrum at some point in their lives, with perhaps the exception of extremely aggressive investments. This is an important part of diversifying investments to minimize risk. You might be a daredevil on the half pipe, but you'll probably own some low-risk government bonds at some point.



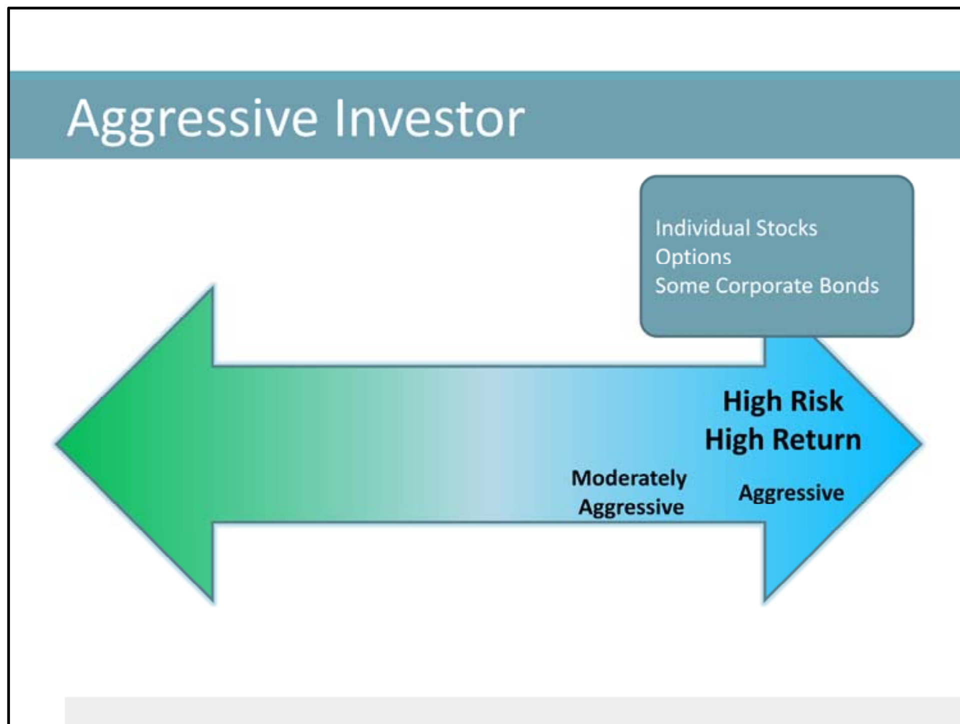
Conservative investors are people who want a predictable return on their investments regardless of how the stock market or the economy is doing. They are willing to give up the potential of making higher returns when the stock market and economy are doing well in order to ensure that their money is safe. In other words, they don't like risk.

Often the people who fall into this category are young people with children who may not have a lot of money invested, and count on that money being available if necessary. Also, many senior citizens are conservative investors because they want to protect what they've earned over the years.



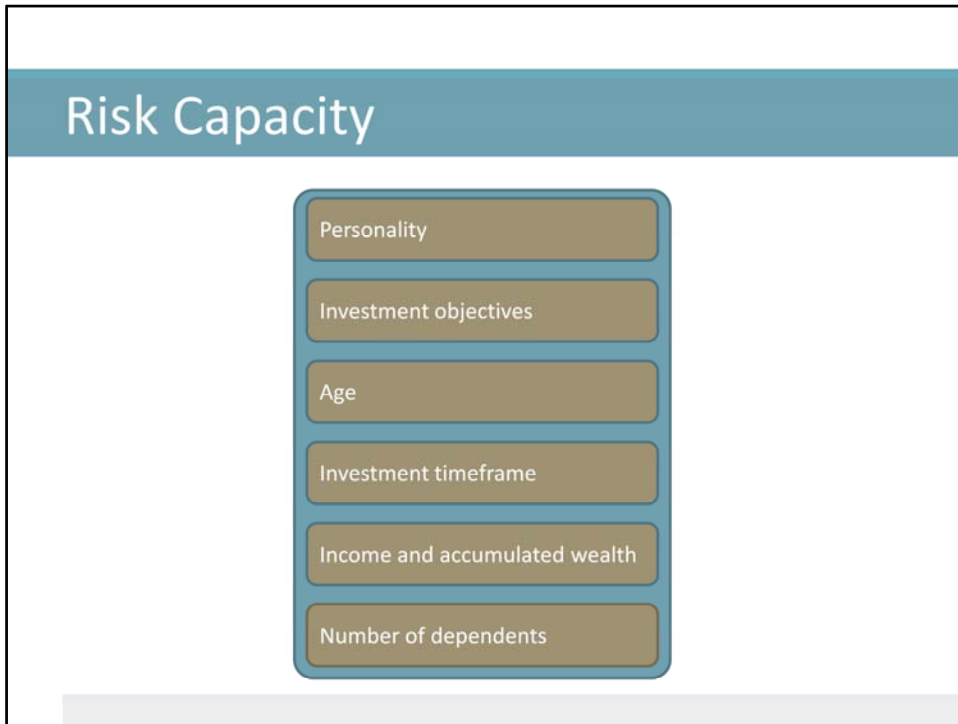
Moderate risk investors are willing to take some calculated risks in order to earn larger rewards. They generally have an investment portfolio that takes advantage when the stock market and the economy go up, but also shields them from big losses during tougher economic times. Most people fall into this category because they understand that they need to take some level of risk in order to achieve their financial goals. This doesn't mean they don't have low or high risk investments, just that the majority of their investments are moderate risk.

Investors in this group have enough money and time to ride out rough economic times. Often they are saving for longer term goals like retirement or paying for their children to go to college.



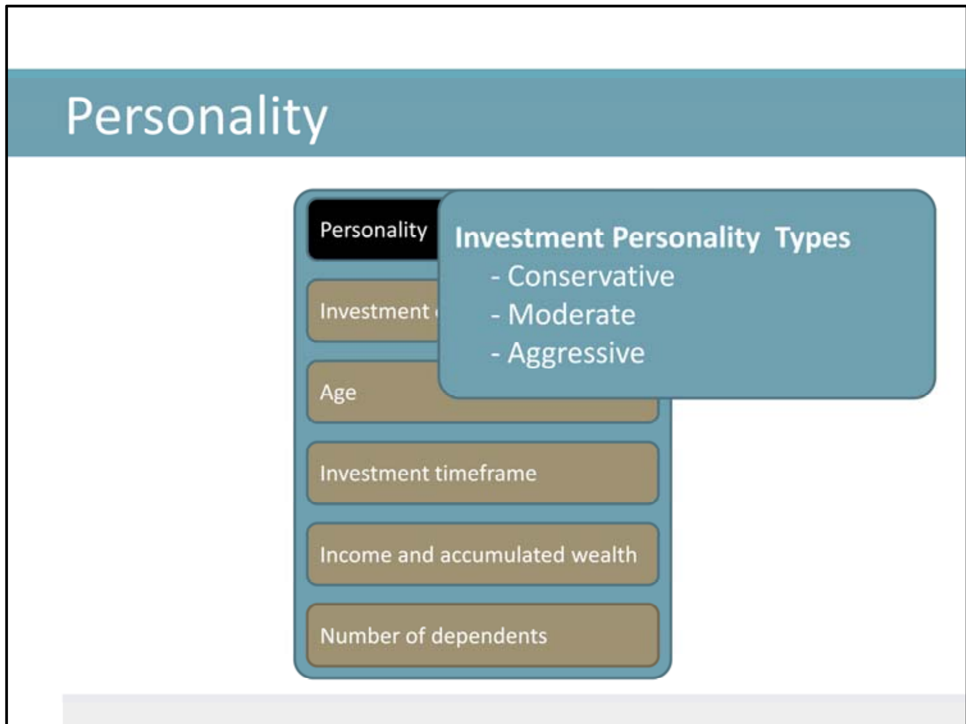
Aggressive investors are those individuals that enjoy taking risks and can afford to buy high risk investments for the chance to make much greater returns. They tend to buy investments that fall on the right side of the risk diagram, such as individual stocks, options and some corporate bonds. Their investment portfolio may go up and down in value throughout the year as their bets either pay off, or lose money.

While all investors may have some aggressive holdings at some time or another, very few people are strictly aggressive investors since you have to have enough money to withstand large swings in the market so that it won't affect your current financial situation, or your long term financial plans.



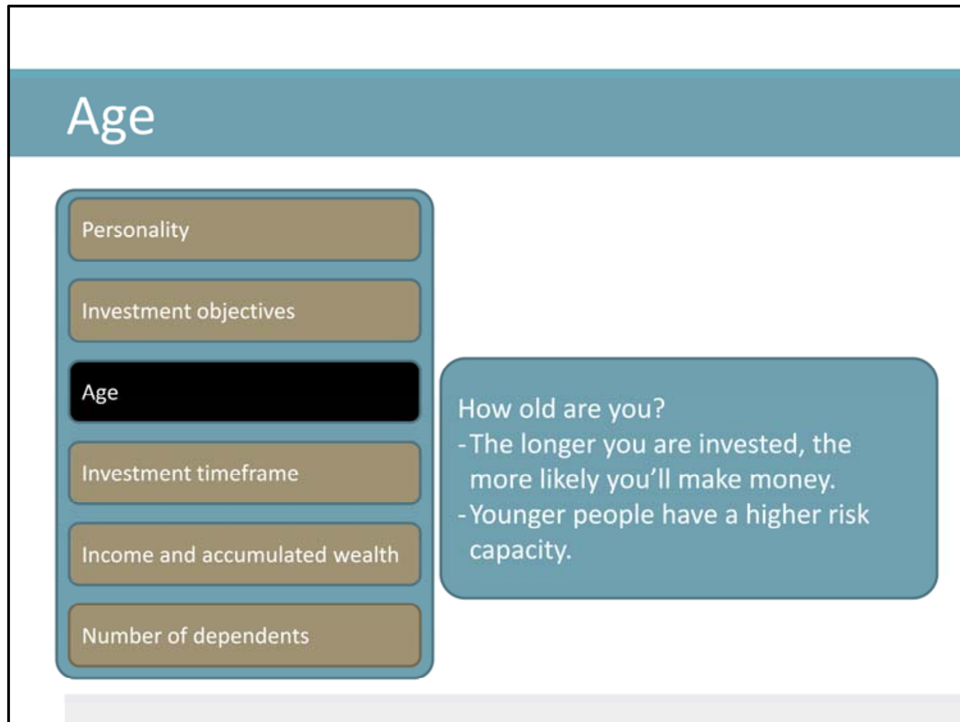
Whether you're gung ho to go out and invest every dollar you have in the stock market, or think that it's much more fun to track the performance of U.S. Treasury bonds, you'll want to look at your risk capacity before you decide to do anything.

Your risk capacity reflects how much risk you'll need to take in order to reach your financial goals. It's based on your life, financial situation and your goals. Let's look at what makes up your risk capacity.



As we just discussed, people tend to fall into one of three categories of investors: conservative, moderate and aggressive. Although this may be your baseline comfort zone, you may need to be more or less aggressive than your natural tendencies based on other considerations.

What are your investment objectives? Are you trying to make money for the future to pay for long term goals, or are you trying to protect the money you've already made? If you are trying to make money for the future, you are going to have to take more risks, and if you're trying to protect your money, you have to avoid risk.



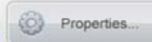
Creating wealth requires both time and money. The longer you stay invested, the greater the chance that you'll be able to ride out the inevitable ups and downs of the stock market and make good returns on your investments. Time also lowers the risk that you'll lose your money.

Young people have time on their side and therefore, generally have a higher risk taking capacity. Of course, your circumstances may change that, for example, a newly-married couple planning to buy their own house cannot afford to lose their savings and so may want to have more low-risk investments.

Who's the Daredevil?

Question 1 of 1 ▾ Point Value: **10**

Who's taking the bigger risk? Select the image and click **Submit**.



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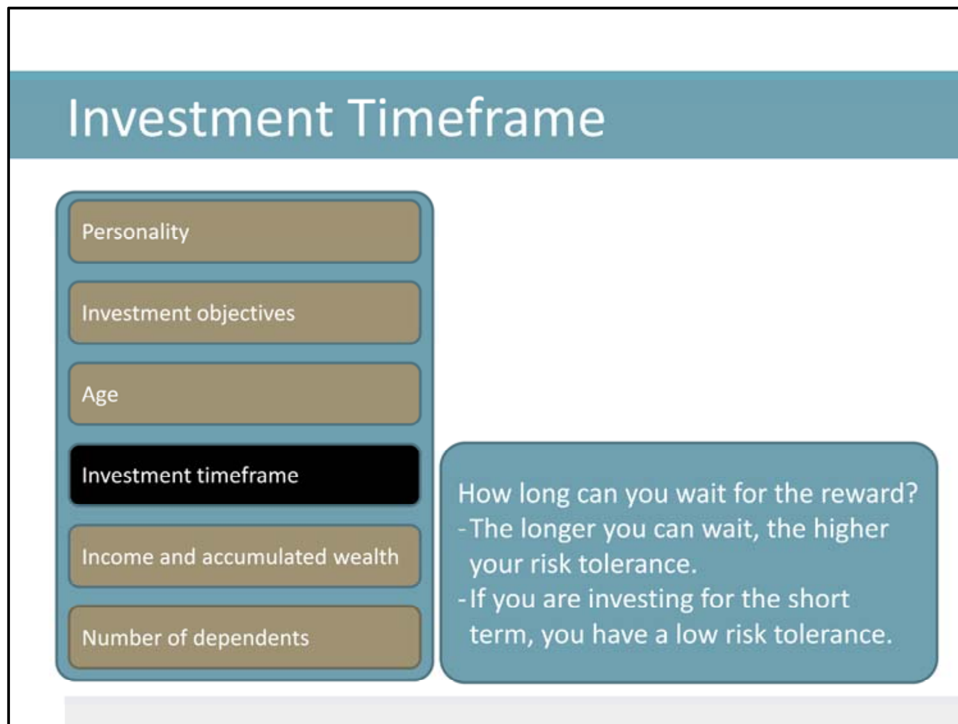

Higher risk investments often take time before they pay off, so the longer you can wait for your investment to generate returns, the more risk you can take. On the other hand, if you are investing for the short term and you are counting on that money being available on a certain date, you should get lower risk investments. That way, you know the money will be there when you need it.

Most experts recommend that as you get closer to achieving a financial goal, switch your money into lower-risk investments, even if it means earning lower returns for a short while.

Imagine that you're saving money for a down payment to buy a house. You've done pretty well with your stock market investments over the past five years. Rather than waiting until the last minute before you go to buy the house, you should start taking your down payment out of stocks and moving it into savings to make sure it's available. Sure, you might have made more money keeping it in the stock market, but there's always the risk that you might lose the money you were counting on as a down payment.

Who is the Risk Taker

Question 1 of 1 ▾ Point Value: **10**

Which one of these people should take the bigger risk based on investment timeframe? Select the image and click **Submit**.

James is investing money for his 8 year-old grandson's

Alex is going to college in the fall and needs money to help pay for

PROPERTIES

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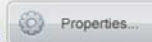
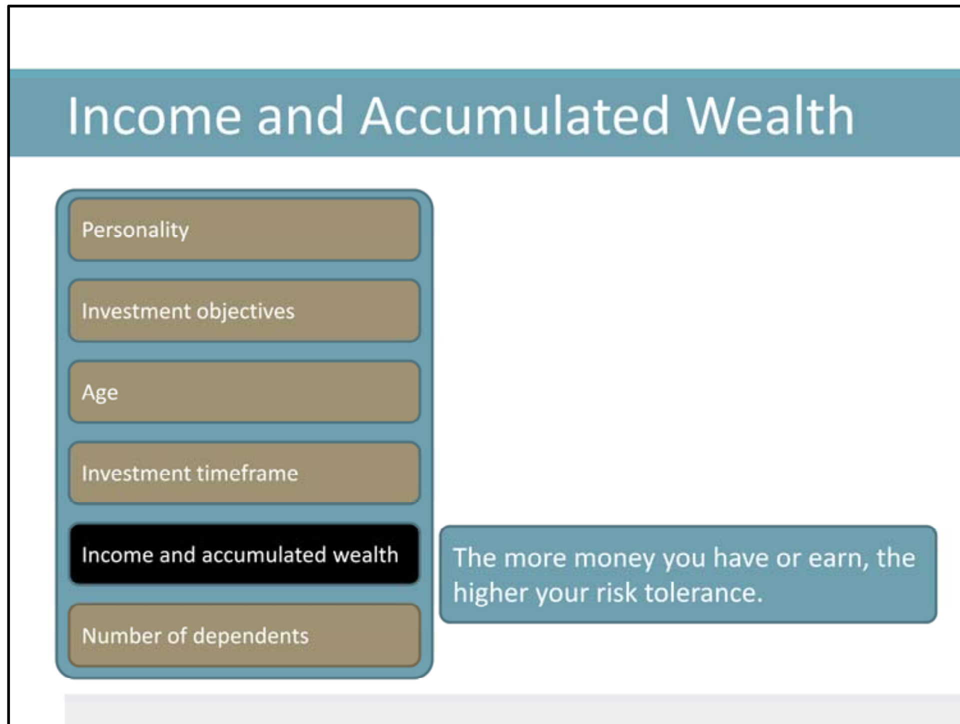
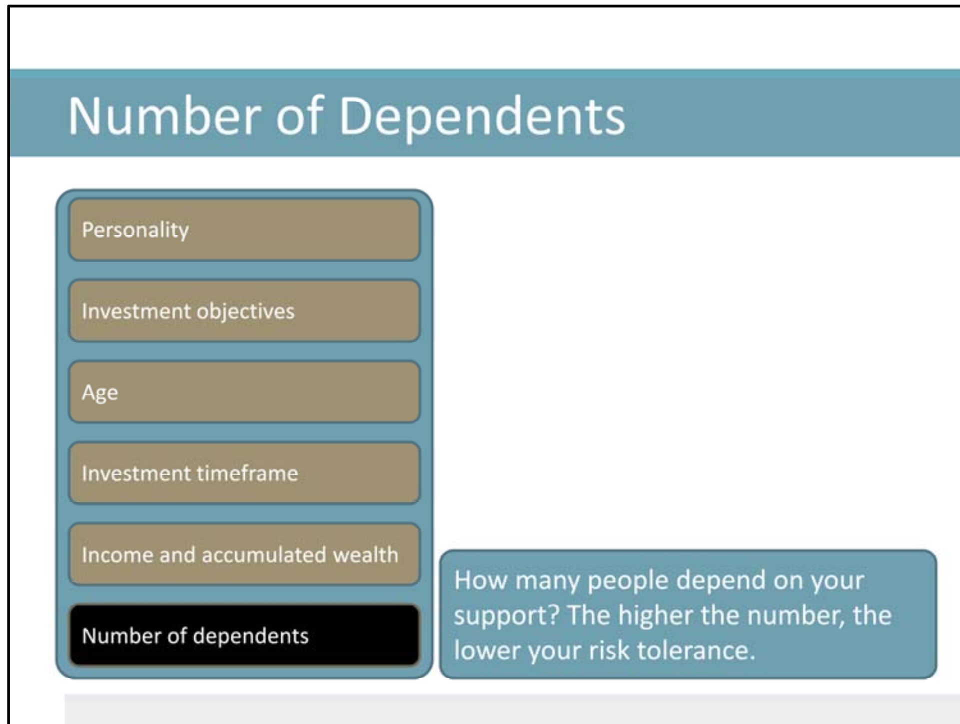
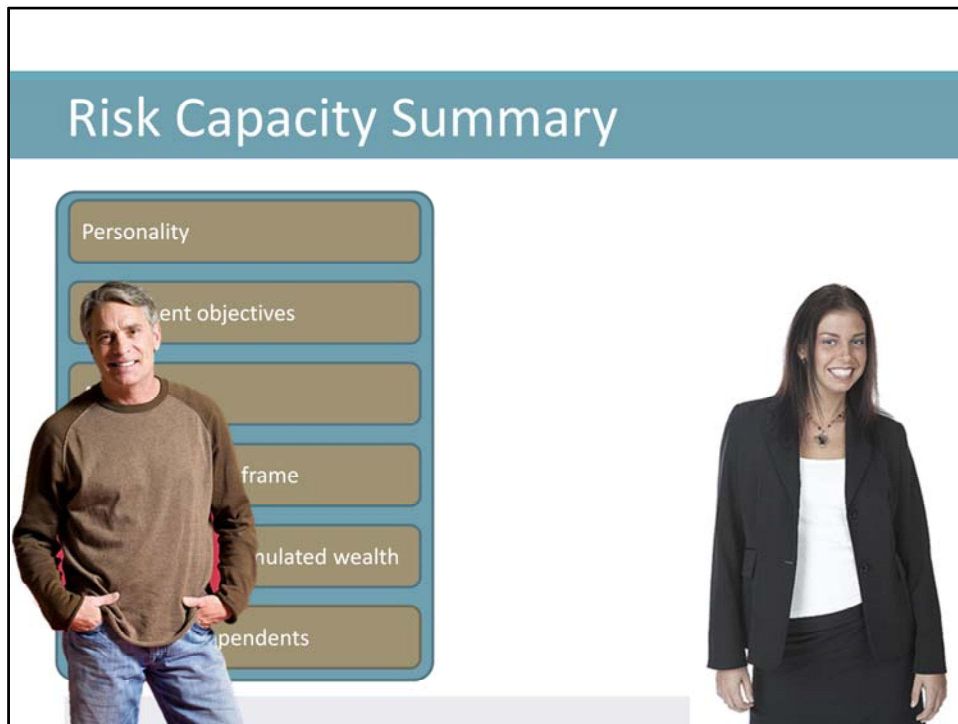




The more money you earn or have saved, the more you can afford to lose. Therefore, you can afford to take more risks with your investments, if you choose to.



You may not be responsible for anyone but yourself right now, but as you get older, you might have children or other people who depend on you for support. The more people you are supporting, the lower the risks you can afford to take with your investments, all other things being equal. If you're only supporting yourself, then you have a lot more freedom to take risks.



Remember that all of these factors come into play when you evaluate your risk-taking capacity, but it’s your specific situation that dictates the final outcome.

For example, you might be a rich man in your sixties with lots of young children who likes to make short term investments because you’re very good at it. Most of the factors suggest that such a man should be making low-risk investments, but certain factors such as wealth and personality may override those. On the other hand, you could be a wealthy woman in her early twenties with no children or dependents, but you don’t like risk and have modest long term financial goals. All the signs point to higher-risk investments, but your investment objectives and personality win out over the other factors.

Use the risk capacity as a guideline for making decisions, and make sure to revisit it as your life changes. It might help to ask yourself, “how much investment risk do I need to take on in order to <fill in the blank> in *x* years?”

So, is there any way to reduce risk while getting higher rates of return? Diversification is the key, but what exactly is it?

Diversification is the process of buying different investments at different levels of risk so that you won't lose a lot of money if one goes down. Instead, you spread your money out so that some of your investments might make money, or at least not lose any when others go down. It's just like the saying "don't put all your eggs in one basket."

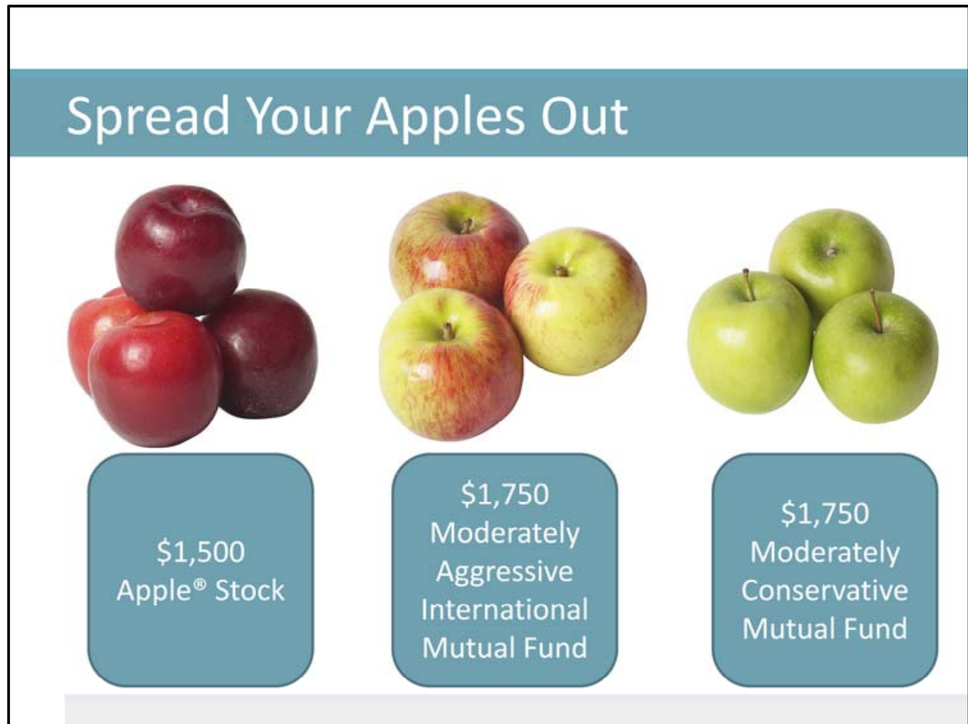
Let's look at a couple of examples of how to do this.

All Your Apples in One Basket

Julie has five thousand dollars she wants to invest. She's done some research on Apple® computers and believes she will get high returns on her money if she buys shares in the company. Should she put all of her money into Apple® stock?

If Julie invests all of her money in this stock, she is betting that Apple’s share price will go up a lot and her rate of return will be very high. What if the stock price goes down due to competition, or other factors? Not only wouldn’t she make her expected rate of return, she could lose some or all of her initial investment.

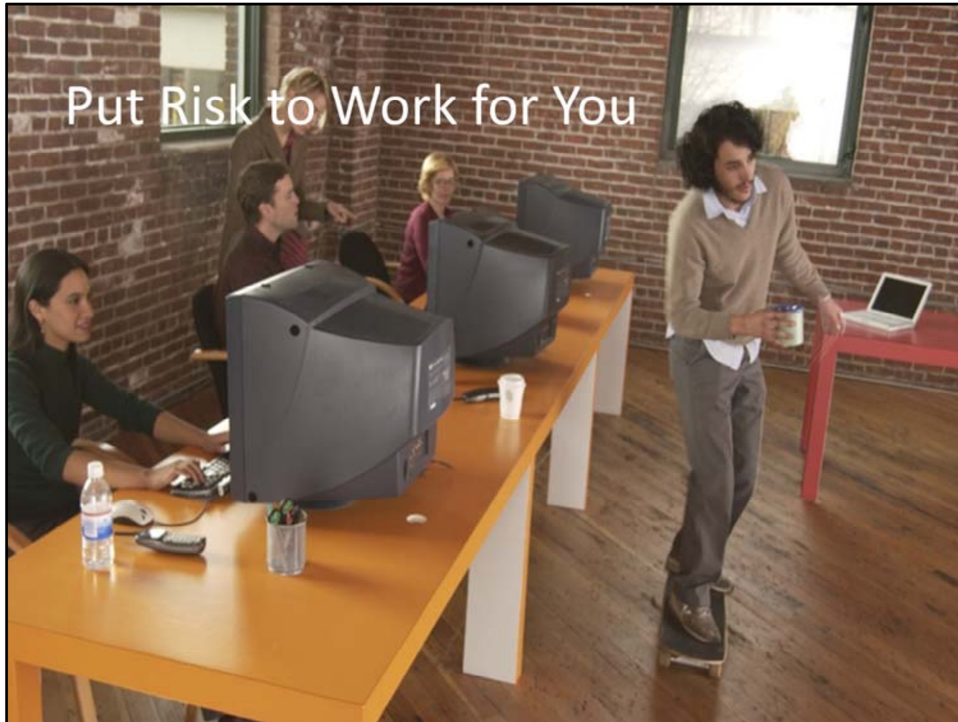
How could Julie diversify to lower her risk of losing money, while maintaining the possibility of high returns?



Instead of putting all of her money in Apple® stock, what if Julie put some in other investments. She still thinks that Apple® is a good bet, so she's going to buy one thousand five hundred dollars of stock. She then splits the remaining three thousand five hundred dollars equally between two mutual funds: one that has a moderately aggressive profile in international stocks, and one that has a moderately conservative approach and is based in big American companies.

She now has money in three different investments. If Apple® stock goes down, then her other investments are somewhat protected. If the U.S. stock market goes down, then she might be protected if international stock markets are unaffected. Finally, if stock markets everywhere go down, then her lower risk mutual fund is relatively safe, although it might go down as well, but probably not as much as the other investments.

By diversifying her investments, Julie is protected from the possibility of losing all the money she invested, while she still gets the chance to make good rates of return if the higher risk investments go up.



Risk is a part of investing, but by understanding how your personality and life situation influences your decisions, and by diversifying your investments to protect against risk, you can learn how to put risk to work for you.