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Viewpoints

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Investing Basics: What Is Risk?

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As part of the ICI Education Foundation's ***30th anniversary celebration****, we will be sharing a series of ICI Viewpoints explaining a basic concept of investing, drawn from the ICI Education Foundation's Investing Road Trip.*

You invest with the hope of earning a return on your investment. That opportunity invariably involves risk, including the possibility of losing some or all of the money you invested. Understanding these risks is an essential step toward successful investing.

You could put your money in a federally insured bank account to protect against market losses—but if you want it to earn bigger returns and to grow, you're going to need to invest it and encounter risks. As noted below, even the most conservative investments pose risks. It's best to do your homework up-front and take on any investment with your eyes wide open.

Types of Investing Risks

Not all risks are the same, and different types of investments have different types of risk. These may include—but are in no way limited to—the following.

- Company-specific risk, a risk of stock investing, is the possibility that a company will face an adverse event affecting its stock price. Here's an example from **ICIEF's Investing Road Trip**: You own stock in a theme park company. A hurricane damages the company's most popular park, which must close for a year. The company's stock price falls.

- Credit risk, a risk of bond investing, is the possibility that a bond issuer will fail to pay back bondholders or otherwise meet its obligations.
- Interest rate risk can affect both stocks and bonds, as changes in interest rates can affect the value of investments across a market. For example, if the Federal Reserve raises interest rates, the value of stocks and bonds may decrease.
- Inflation risk is the possibility that your investment won't grow enough to keep pace with the rising costs of goods over time. This risk is particularly important to consider for conservative investments, like certificates of deposit and money market funds. Though they may seem "safe" because there's little risk of seeing their value drop, you may be left with less real purchasing power than when you bought the investment if the rate of inflation is higher than the investment's rate of return.

Understanding the Risks of an Investment

In the United States, companies that issue stocks and registered investment funds, such as mutual funds and exchange-traded funds (ETFs), are required to disclose investment risks on a regular basis. These risk disclosures are reported to the Securities and Exchange Commission (SEC) through Form 10-K (for publicly traded companies) and through the prospectus and annual shareholder reports (for mutual funds and ETFs). You can research the risks of a potential investment on the **SEC's EDGAR website**. If you're investing in a mutual fund or ETF, the fund manager's website will also provide the prospectus and annual shareholder reports, as well as historical performance and more fund information.

Assessing Your Risk Tolerance

As an investor, your first step in selecting an investment should be to consider its investment objective and how it fits with your own goals for the investment. Then, you can look at the risk profile of the investment and weigh these risks against their potential returns—and against your own personal comfort level with risk, or your "risk tolerance."

Although the past performance of an investment cannot predict its results in the future, looking at past returns will give you an idea of its behavior in different market conditions—and whether you would have been comfortable with those results. Volatility is a normal part of investing and investors with long-term goals should expect setbacks from time to time. If you maintain a long-term perspective, short-term swings become less significant.

But above all, if you can't afford the risk, don't buy the investment.

Other Posts in This Series

- **Investing Basics: What Is Investing?**

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