



To most people, “risk” evokes negative images — driving recklessly on a highway, placing bets on “a long shot,” or traveling alone to unfamiliar places. Mention risk in terms of investing, and people might think about losing their life’s savings. But in reality, investment risk comes in many forms, and each can affect how you pursue your financial goals. The key to dealing with investment risk is learning how to manage it within a portfolio designed to help you reach your financial goals and dreams.

Step One: Understand Risk

Barron’s *Finance and Investment Handbook* defines risk as the “measurable possibility of losing or not gaining value.” Fear of losing some money is probably one reason why people may choose conservative investments, even for long-term savings. While investment risk does refer to the general risk of loss, it can be broken down into more specific classifications. Familiarizing yourself with the different kinds of risk is the first step in learning how to manage it within your portfolio and therefore be positioned to make better investing decisions.

Varieties of Risk

Risk comes in many forms, including:

- **Market risk:** Also known as systematic risk, market risk is the likelihood that the value of a security will move in tandem with its overall market as opposed to any news specific to the security. For example, if the stock market is experiencing a decline, the stock mutual funds in your portfolio may decline as well. Or if bond prices are rising, the value of your bonds may also go up.
- **Security risk:** Associated with the lack of diversification, this is the risk that a specific security will perform well or poorly due to something specific to that security as opposed to price movement associated with the market in general. For example, if a specific technology company announces that its sales and profits declined by 10% while technology companies in general are achieving strong growth, that company’s stock may decline significantly while technology company stocks in general move upward.
- **Interest rate risk:** Most often associated with fixed-income investments, this is the risk that the price of a bond or the price of a bond fund will fall with rising interest rates.

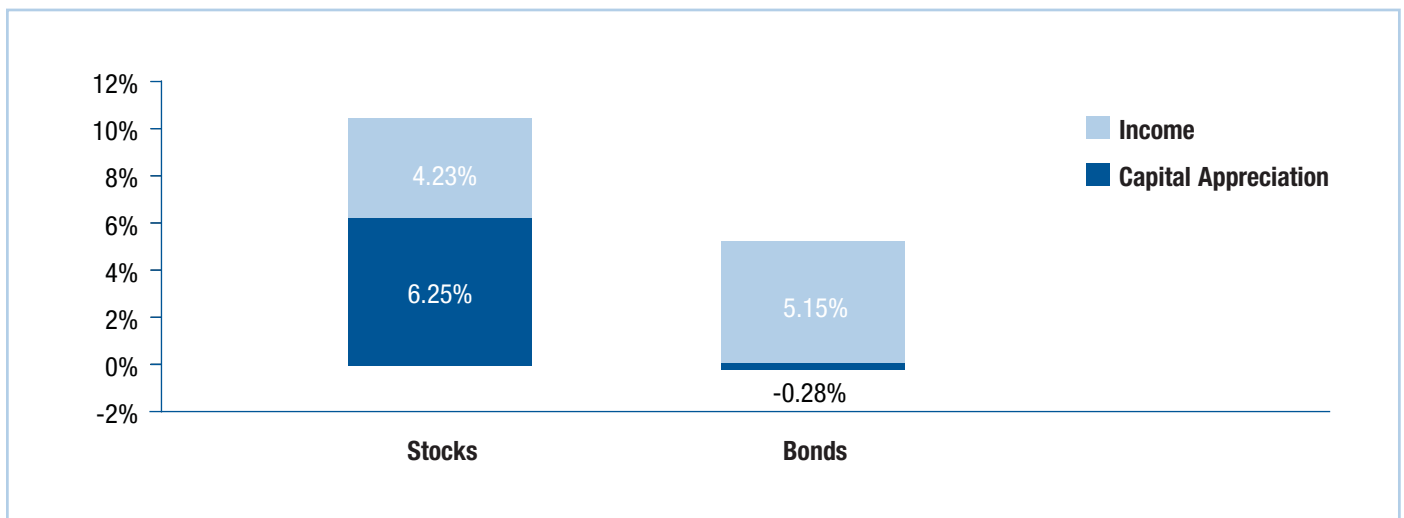
- **Inflation risk:** This is the risk that the value of your portfolio will be eroded by a decline in the purchasing power of your savings, as a result of inflation. Inflation risk needs to be considered when evaluating conservative investments, such as bonds, bond funds, and money market funds¹ as long-term investments. While your investment may post gains over time, it may actually be losing future purchasing value if it does not at least keep pace with the rate of inflation.
- **Credit risk:** This type of risk comes into play with bonds and bond funds. It refers to a bond issuer's ability to repay its debt as promised when the bond matures. Bonds and bond funds are given credit ratings by such agencies as Moody's and Standard & Poor's. In general, the higher the rating, the lower the credit risk. Junk bonds, which generally have the lowest ratings, are among the riskiest in terms of credit. People who invest in them typically seek higher yields to compensate for their higher credit risk.

International investments also involve additional risks, including the possibility of fluctuating currency values (currency risk) and the risk that political and economic upheavals may affect a country's markets.

Step Two: Diversify

The adage "Don't put all your eggs in one basket" is applicable to the realm of investing. The process of diversification, or spreading your money among several different investments and investment classes, is used specifically to help minimize the overall risk in a portfolio. Because they invest in many different securities, mutual funds or professionally managed accounts may be ideal ways to manage Security risk. Selecting more than one mutual fund for your portfolio can help further reduce risk, especially if you select funds from more than one asset class: when stocks are particularly hard hit due to changing conditions, bonds may not be affected as dramatically. In part, that may be because bond total returns may be tied more to income (which can cushion a portfolio) than price changes (see chart). Remember, diversification does not eliminate risk, but is helpful to manage risk.

Components of Total Return, 1926-2006



Sources: Standard & Poor's; the Federal Reserve. Stocks are represented by Standard & Poor's Composite Index of 500 Stocks, an unmanaged index considered representative of the stock market. Bonds are represented by long-term (10+ years) Treasuries. Results include reinvested dividends. Investors cannot invest directly in any index. Past performance is no guarantee of future results

Step Three: Match Investments to Goals

Before you can decide what types of investments are appropriate from a risk perspective, you need to evaluate your financial goals. Is your goal preservation of principal, generating income for current expenses, or building the value of your portfolio over and above inflation? How you answer this will enable you to find an appropriate balance between the return you hope to achieve and the risk you are willing to assume.

Examine your time horizon for meeting your goals, and consider how comfortable you may be riding out short-term losses in the value of your investments. Remember, the longer your time horizon, the more volatility you may be able to tolerate in your portfolio as the general long-term trend of the markets has historically been upward. At the same time, long-term investors need to be concerned about inflation.

For example, investors pursuing long-term goals (such as retirement) may be most concerned with long-term wealth growth and minimizing inflation risk. Their portfolios may be more heavily weighted in stock investments, as these have historically provided the highest long-term returns and outpaced inflation by the widest margin, although past performance does not guarantee future returns. These investors may also devote some money to bonds and money market investments¹ to help balance the higher risks associated with stocks by smoothing the fluctuations and to generate some income from the portfolio.

On the other hand, people already in retirement may need to rely heavily on the income from their portfolios. Therefore, they may seek to maximize income and minimize risk of short-term losses. Their portfolios may be weighted in an array of fixed

income investments, with some stocks in the mix to maintain growth potential against the corrosive effects of inflation.

Risk Involved in Various Investments²

	Volatility Risk	Inflation Risk	Credit Risk
Stocks	High	Low	N/A
Government Bonds	Medium	High	Low
Money Market Funds	Low	High	Low
Small-Cap Stocks	High	Low	N/A
High-Yield Bonds	High	Medium	High

When thinking about how to balance risk and return in your portfolio, don't forget that the risk of loss is not the only kind of risk. Give some thought to the risk of investing too conservatively and not reaping a high enough return to provide for your financial future. Also be aware of investing in instruments that may be too risky for your shorter-term goals.

Using Risk to Its Full Potential

In life, almost every attempt at success involves some risk — and your investment strategy is no different. By devoting time to knowing and understanding your goals, understanding the types of risks associated with investments, and working with a financial advisor focused on helping you achieve your specific goals, you can learn how risk is being managed in your portfolio and make smarter investment decisions.

Points to Remember

1. Investment risk comes in many forms, and each can be used as a tool in pursuing your financial goals. The key to dealing with investment risk is learning how to manage it, primarily through proper diversification.
2. Market risk is the likelihood that a security's value will move in tandem with its overall market.
3. Interest rate risk is the risk that the price of a bond or the price of a bond fund will fall with rising interest rates.
4. Inflation risk is the chance that the purchasing power of an investment will be eroded by inflation.
5. Credit risk comes into play with bonds and bond funds. It refers to a bond issuer's ability to repay its debt as promised when the bond matures.
6. Before you can decide what types of investments are appropriate from a risk perspective, you need to know and prioritize your financial goals. A professional financial advisor is instrumental in helping you build an appropriate portfolio to achieve your goals.

For more information, please contact your financial advisor.

Important Additional Notes

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1 An investment in a money market fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the fund seeks to preserve the value of your investment at \$1.00 per share, it is possible to lose money by investing in the fund.

2 Sources: Standard & Poor's; the Federal Reserve. Stocks are represented by Standard & Poor's Composite Index of 500 Stocks, an unmanaged index considered representative of the stock market. Bonds are represented by long-term (10+ years) Treasuries. Inflation is represented by the Consumer Price Index. Results include reinvested dividends. Investors cannot invest directly in any index. Past performance is no guarantee of future results.

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