# Risky Business?

## Types of Investments

## Taking a Chance

If you could select any weekend activity, what would you choose? Would you skydive, skateboard, ride a bike, or read a good book? If you're a risk-taker, you might try something new, such as jumping out of an airplane (expecting your parachute to work). If you're *not* a risk-taker, you might stick with something more familiar, such as reading the next book in your favorite series.

### Objectives:

A. Explain the relationship between risk and return.

B. Describe the risks and returns of lending investments.

C. Describe the risks and returns of ownership investments.

### Why Risk It?

People who face **risk** (the possibility of loss) with a positive attitude are described as risk-takers. Risk-takers know that trying something doesn't guarantee success. But, they're willing to "chance it" for the potential of **return** (reward or benefit). For a skydiver, the return is the thrill of the experience. For an investor, the return is what the investment could earn—the additional money s/he could receive.

Investors know they're taking a risk when they invest. They could lose money: They might not get back more than they've put in, or they might lose everything they've invested. So, why would anyone want to invest? For the earnings, pure and simple. Accepting a level of risk is just part of investing.

### Can You Handle It?

If you're an investor and you want the potential of a high return, you accept a high risk. If you can't handle a high risk, you select a moderate- or low-risk investment, instead—with the understanding that taking a lower risk brings you the potential of a lower return, in general.

What determines how much risk you can handle? Three things: what you want to accomplish, how much time you have to accomplish it, and your personality. Say you have two goals: to buy a house and to save for retirement. If you're in your teens or twenties, preparing for retirement is a long-term goal, while saving for a down payment is something you could do in just a few years. This means that for your retirement investment, you might take a little more risk—because you don't need the money right away. For your down payment, however, you wouldn't risk what little you have so far—because you're going to need

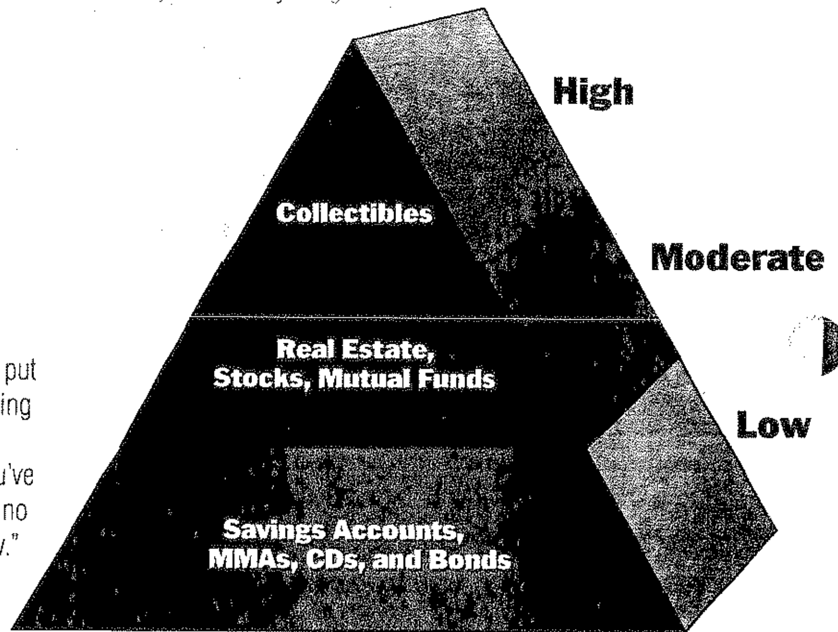
the money in the near future. Even so, the goals you set and the time you have available are not the only determining factors. If you have a personality that is uncomfortable with risk, you might not care how much time is involved. You might be willing to sacrifice the reward you *could* gain in the future for the certainty you have *right now.*

Investors who try to avoid risk are mainly interested in protecting their initial investments—and they should be! To "grow" your money, you need to make sure that what you've put in will remain safe. Before you invest your money in something specific, consider how *likely* it is that you'll lose your initial investment. When there's a good chance you'll lose what you've invested, the risk is "high." When there's a small chance (or no chance) that you'll lose what you've invested, the risk is "low." Higher risks usually bring higher returns.

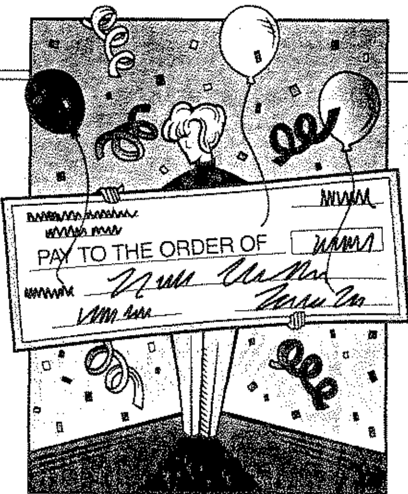
## That's How I See It!

One way to see your investment risk in perspective is to look at the risk pyramid, a graphic way of comparing investments. With high-, moderate-, and low-risk categories, the pyramid helps you to see which investments are more or less risky than others. Near the peak are the most risky investments, while at the base are the most reliable returns.

If an investment you're considering is located near the middle of the pyramid—but you think you can handle more risk—you might select an investment closer to the peak. If you feel that you can't afford any large losses right now, you might choose an investment closer to the base. When you visualize how likely it is that you'll receive a particular return, you see which selection will move you toward your goal.




**Investment Risk Pyramid**



Skeptics may think that investing is similar to playing the lottery. Yes, investing is risky, but wise investors make sure their chances of succeeding are good. With the Mega Millions lottery, the chances aren't so good: about one in 135 million. Buying two tickets increases the odds to only *two* in 135 million. Still not very promising!

# Getting a Little Something Extra

Right now, you could select from almost any number of investment opportunities to make your money work for you. These opportunities are called **securities**—the legal lending or owning agreements between individuals, businesses, or governments. Since there are a number of securities, you might find it helpful to separate them into "lending" and "owning" categories. These categories are sometimes referred to as "debt" and "equity."

Investors who can't handle much risk put their money into lending investments. With a **lending investment,** you allow someone to borrow your money for a period of time—for a price. The extra money you receive provides the motivation for lending. Examples of lending investments are savings accounts, money market accounts, certificates of deposit, and bonds.

## Types of Lending

A **savings account** is a lending investment in which you lend money to a bank for the benefit of being able to access your money anytime. Of course, you can access your money if it's hidden in your sock drawer, too. The difference is you get paid to put your money in a savings account—and that's what motivates people to do it.

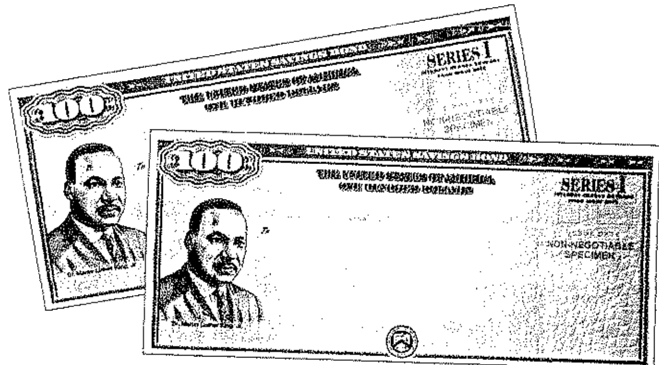
Another benefit is that you can leave your money in a savings account for an indefinite period of time. This means that you don't have to move your savings from one place of investment to another. You can keep a savings account open for your entire life.

The downside to a savings account is twofold. First, you receive a low return. (Right now, savings accounts are returning about 1% interest per year, if you're lucky.) Second, the low return doesn't even keep up with inflation—which is a double-whammy. Your savings grows at a slower rate than the cost of goods and services. In effect, your money has less buying power.

Another bank account that earns interest is a **money market account** (MMA). With an MMA, you can access some of your money each month—but not all of it. For a little less freedom, you get a better interest rate. (Current MMA rates are around 2 or 3%.) You can keep your money in an MMA for an indefinite period of time, but you usually have to keep a certain *amount* of money in your account.

A **certificate of deposit** (CD) is a lending investment in which you lend money to a bank at a set interest rate for a particular period of time. Typical time frames can be as short as one month or as long as five years. With CDs, you are guaranteed a certain rate of return, but you can't access your money before the end of the time period without paying a penalty. By giving up the right to use your money for a period of time, you can earn a higher return than with a savings account or an MMA. Good interest rates for five-year CDs are currently around 4%. To get this interest rate, though, you usually have to invest a minimum amount of money—such as $500 or $1,000.

While a CD is offered by a bank, a **bond** is offered by a government, municipality, or corporation. A bond is similar to a CD in that it's a lending investment at a set interest rate for a particular period of time—such as a year, 10 years, or longer. But with a bond, you don't pay a penalty if you withdraw the invested amount before the end of the time frame. You just lose the amount you would have received if you'd left it alone.




In general, bonds are considered to be *guaranteed* money: They are very low risk. For the low risk, you have to be willing to leave your money with the borrower for the entire time period. In some cases, that's 30 years! But, the reliability of bonds appeals to many investors who can handle only small amounts of risk.

> **1.2% 4% 3%**
>
> You can research the current interest rates for bank accounts and CDs at www.bankrate.com.

# Catching a Piece of the Action

Investors who are not afraid to take a big risk put their money into **ownership investments**—the investments that provide owners' rights in return. Types of ownership investments include stocks, mutual funds, real estate, and collectibles. Each ownership investment provides an opportunity for a return by letting you own something of significance. Let's take a look at each.

## Stocks

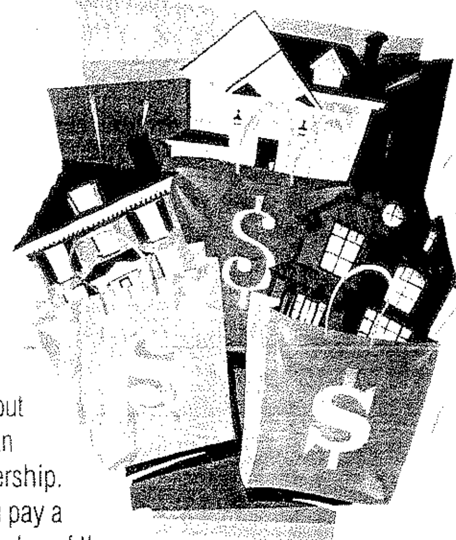
A **stock** (or share) is a piece of paper—whether real or virtual—that says you own part of the corporation. As an owner (or shareholder), you have the rights and responsibilities of ownership. This means you can attend shareholders' meetings, vote for issues you support, and receive a portion of the company's earnings. In addition, you may be able to sell your stocks for a profit, making a sizeable sum of money. But, being an owner also means you risk losing money. If your stocks decrease in value, you can lose a lot. If the corporation goes out of business, you can lose your whole investment—because, as an owner, you're part of the corporation. (Since bond holders are *not* owners, they will get paid back before you.) But, even if the corporation *doesn't* go out of business, you can lose everything you've invested just due to the up-and-down nature of stock values.

## Mutual Funds

If you're concerned about risk, you could invest in a stock mutual fund. A **stock mutual fund** is a combination of stocks from different corporations or agencies, usually from different industries. The idea behind mutual funds is that you don't take as much of a risk as you do when you buy individual stocks—but, as an owner, you have a good chance of receiving a return. How much you receive usually depends on how much risk you're willing to take. If you buy a combination with more risk, you might get a greater return.

One benefit to investing in mutual funds is access to the expertise of the fund's manager. The manager is directly responsible for deciding which investments best meet the mutual fund's stated purpose. Fund managers can make mistakes, though, so you should pay attention to who's in charge of directing your fund. You should also find out about any fees associated with a mutual fund. Fees vary dramatically and can negatively impact your return.

## Real Estate



Another ownership investment is **real estate.** You can buy a home to live in, a vacation home for the summer, an investment property that will bring in rent money, or land that might be developed sometime in the future. There are a lot of choices, but the one almost everyone can participate in is home ownership. When you buy a home, you pay a certain amount toward the value of the house. While you're living there, the home's value can increase along with the property values around you. This means that for the amount of money you invest, you are likely to get more out of the real estate than you pay for it.

With property values, your day-to-day risk is depreciation, the loss of value due to market forces. This means that if others see your property as less valuable, your real estate is not worth as much. When other properties around yours decrease in value—because they're run-down or flood-prone—you suffer, too.

## Collectibles

If you've ever collected baseball cards, you know something about **collectibles**—items that gain or lose value over time. You buy a baseball card when it's not too expensive, and you wait for it to become really valuable. Once it's worth a lot more than you paid for it, you sell it to someone else to make a profit. Sounds easy, doesn't it?

Getting a good return from a collectible, though, depends on two key things. You have to be sure that the item is important to other people, not just you. And, you have to be sure that the item will be *more* important to other people *in the future*. It's impossible to be absolutely certain of either one of these two things. That's what makes a collectible item a risky investment. You might not be able to sell the item at all—let alone for more money than you've paid for it.

Even so, many people enjoy investing in collectibles such as antiques, gems, stamps, dolls, or sports memorabilia, for instance. When investors *like* to collect these items, you figure that they probably don't mind keeping some of the things they can't sell.