# Investment Portfolios

*by Sophia*

WHAT'S COVERED

In this lesson, you will explore the expected relationships among risk, return, and marketability. You will reflect on using problem solving skills to determine your risk tolerance. You will also examine how strong technology skills can be a benefit in several ways. Specifically, this lesson will cover:

# 1. The Three Rules of Risks

Risk can be defined in numerous ways. However, within the domain of investing, financial risk includes the possibility of gains and losses, as well as threats associated with losing purchasing power, business failure, and other negative events. You can think of investment risk as uncertainty or **volatility** relating to a particular investment. Investing in stocks, for instance, is risky because you cannot know for certain if your investment will turn out well or badly, nor can you predict how much you may gain or lose (although it is always possible to lose 100% of your investment). One of your investment objectives should therefore be to manage your decisions to maximize returns while minimizing risks. In this section, we review the three rules of risk that can help you in this regard.

TERM TO KNOW

**Volatility**

The value of an asset fluctuating up and down or the variability of returns over time.

## 1a. Rule 1: Greater Financial Risks Are Associated with Higher Expected Returns

To earn higher returns on your savings and investments, you must be willing to take calculated financial risks in the investment marketplace.

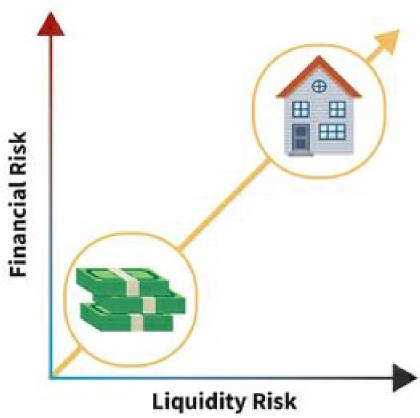
- The association between taking risks and obtaining returns is shown in the line graph below.
- The relationship is positive. This means that you must be willing to move some of your savings and investment money out of safe, secure, and insured accounts into investments like stocks, bonds, mutual funds, and exchange-traded funds to generate higher returns. Remember, these are smart, well-diversified risks; you are not betting everything on one investment.


## 1b. Rule 2: Financial Risk Increases as Asset Liquidity Risk Increases

By taking increased risk, you will be giving up some of your liquidity. Liquidity risk refers to how quickly you can convert an asset to cash without a price concession or loss.

- Your most liquid asset is the money in your pocket.
- On the other end of the liquidity spectrum is real estate. It can take a long time to complete the sale of a property and then longer still to receive cash from the sale.
- Liquidity also includes your ability to hold onto an investment over long periods of time so that the long-term prospects of the investment can fully materialize.

By definition, as the following line graph shows, as an asset's liquidity risk increases, so does financial risk. So back to Rule 1: if financial risk increases, so should the amount of return you expect, or demand, on your investment.



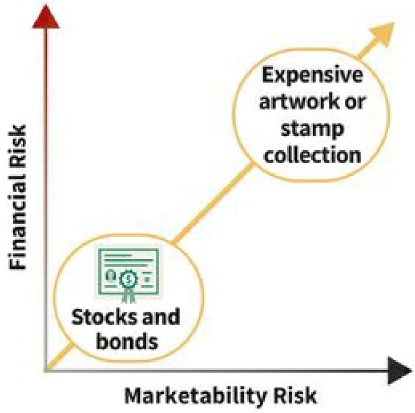

## 1c. Rule 3: Financial Risk Increases as Marketability Risk Increases

It is always easier to buy something than it is to sell it (think about sports memorabilia and collectibles).

- Depending on the asset, it can sometimes take a long time to find a buyer.
- Depending on when you want to sell your investment, it may also seem unattractive to buyers (e.g., property insurance stock immediately following a hurricane or major natural disaster). But if you are able and willing to wait until the market for insurance stocks improves, you may get a much better price when selling.
- The sales process gets complicated because you can never be sure how much you can get others to pay for the things you own.
- This is why the marketability of assets is tied to risk.

As the following line graph shows, marketability risk, or the ability to sell your asset relatively quickly and receive cash in a timely manner, can affect the riskiness of an investment. Here is what you need to know about investment marketability risk:




- The marketability risk of stocks and bonds is low. In fact, each securities exchange operating in the United States ensures that a market exists for most stocks and bonds. This is the reason some investors prefer U.S. stocks and bonds over other investment options.
- While stocks and bonds can be sold quickly, the price of a given stock may fall or increase quickly. This can happen when bad news about a company is first reported. While you can still sell your stock, the market for the stock may not be as strong as it was before the bad news. It may be best to wait, if possible, until the market for the stock improves.
- Assets that are bought and sold in lightly traded markets have more marketability risk. This risk creates special financial risks for investors.

## 1d. Bringing the Rules Together

Essentially, to obtain higher returns, you must be willing to:

1. Take greater financial risk.
2. Sacrifice some liquidity (take on liquidity risk).
3. Give up some marketability (increase marketability risk).

On the other hand, just because an asset is liquid and marketable does not mean that you are guaranteed to make money. There is still a risk that a safer investment will not translate into profits, which is why investments in general will generate higher returns than savings options.

**Problem Solving: Skill Reflect**

Only you can decide if financial risk is worth it. Strong problem solving skills will allow you to weigh your options. Consider your current finances. Would you feel confident about taking a big risk right now? Could you afford a large loss if things did not work out?

**BIG IDEA**

So, before you start investing, you should definitely consider your overall tolerance for risk.

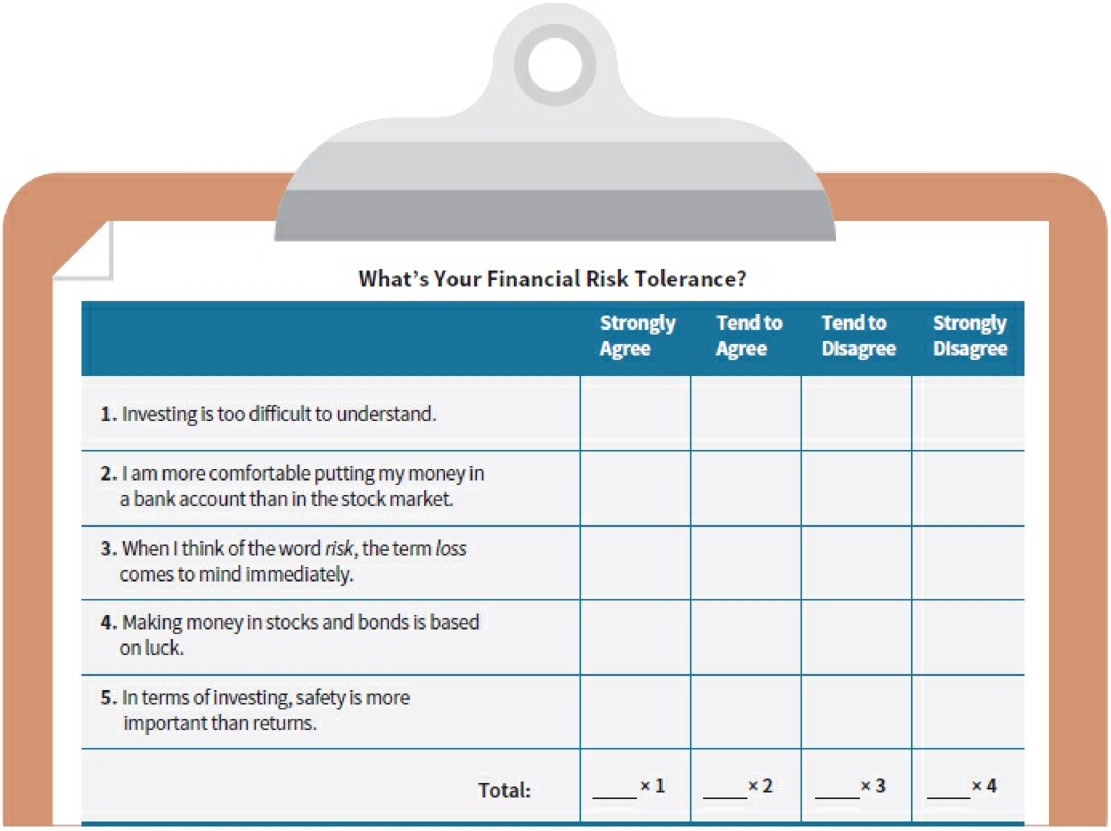
# 2. Risk Tolerance and Your Portfolio

The key to earning higher returns is being willing to take greater reasonable financial risks with your money. Recall that your willingness to engage in risky financial behavior in which the outcomes are both unknown and potentially negative is termed your risk tolerance. Your risk tolerance encompasses a wide range of attitudes, including your willingness to invest in assets with (1) liquidity risk and (2) marketability risk.

Let's see how you can match your financial risk tolerance with some specific investment options. First, you need some measure of your willingness to take risk.

## 2a. Measuring Your Risk Tolerance

Your first step in measuring your risk tolerance is to indicate your level of agreement with the statements in the following questionnaire.



**What's Your Financial Risk Tolerance?**

| | Strongly Agree | Tend to Agree | Tend to Disagree | Strongly Disagree |
|---|---|---|---|---|
| **1.** Investing is too difficult to understand. | | | | |
| **2.** I am more comfortable putting my money in a bank account than in the stock market. | | | | |
| **3.** When I think of the word *risk*, the term *loss* comes to mind immediately. | | | | |
| **4.** Making money in stocks and bonds is based on luck. | | | | |
| **5.** In terms of investing, safety is more important than returns. | | | | |
| **Total:** | ____ × 1 | ____ × 2 | ____ × 3 | ____ × 4 |

Source: This scale was adapted from J. Grable and S. Joo, "A Further Examination of Financial Help-Seeking Behavior," *Financial Counseling and Planning* (*12*(1), 2001), pp. 56–66.

To calculate your risk-tolerance score, add up the points for each question. A score of 7 indicates a very low level of risk tolerance. An economist would say someone with this score is extremely risk-averse. A score of 18, on the other hand, is a sign of very high risk tolerance. A score between 11 and 14 represents middle-of-the-road risk tolerance.

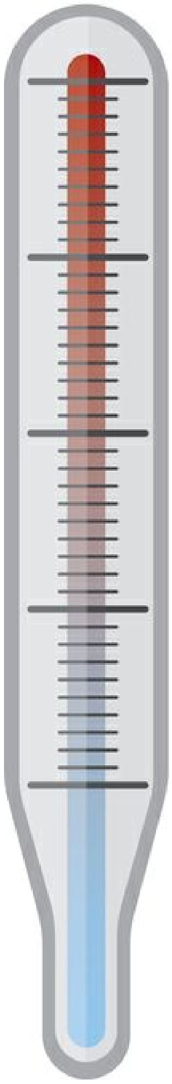
HINT

Don't worry about your score at this point. If your risk tolerance is on the low side, it is almost certain that, as your financial knowledge and experience increase, your risk tolerance will increase as well.

## 2b. Matching Your Risk-Tolerance Score to Investment Alternatives

Once you know your risk-tolerance score, you can match it to the investments shown in the illustration below.

This illustration provides examples of investments discussed in this chapter, with a general approximation of the risk associated with each investment. Note that very high-risk-tolerant individuals may choose to invest in commodities, which are basic goods in the economy such as oil, food stocks, and precious metals. These can be very risky investments.



| Risk-Tolerance (score) | Investment Asset |
|---|---|
| Very high (19–20) | Everything listed, plus other investment assets (commodities, collectibles, speculative stocks) |
| High (15–18) | Bonds, stocks, and real estate (junk bonds, medium- and small- company stocks, international stocks, investment real estate) |
| Moderate (11–14) | Bank products, bonds, and stocks (long-term CDs, investment -grade bonds, highly regarded and well-known stocks, balanced mutual funds, ETFs) |
| Low (7–10) | FDIC-insured bank products and bonds (short-term CDs, online savings accounts, savings bonds, Treasury bonds, highly rated corporate and municipal bonds) |
| Very low (5–6) | FDIC-insured bank products (savings accounts, money market savings accounts) |

Two caveats are worth mentioning at this point.

1. It is unlikely that you will ever be forced into choosing investments from just one category. It is much more likely that you will end up building an investment portfolio that includes investments from several categories.
2. You must also consider your goals and time horizon when looking at the investment alternatives in the previous illustration. If you are young and saving for retirement, for example, you can afford to take on moderate, high, or even very high financial risk because you have the time to recoup financial losses. If, on the other hand, your goal is to save for a down payment on a house, you should look for investments that generate consistent returns with low levels of financial risk, regardless of your risk tolerance.

**BIG IDEA**

Your goal should be focused on building a diversified portfolio.

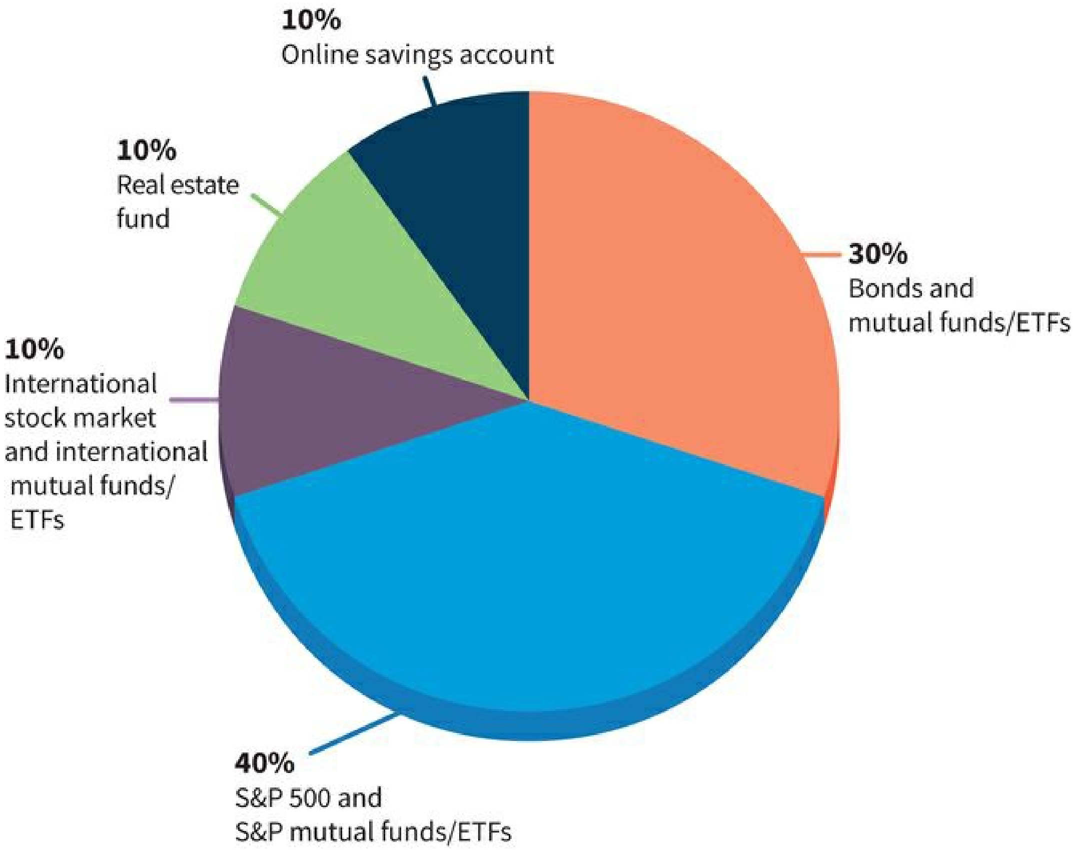
As you can tell, when it comes time to developing a portfolio, there is a lot to think about. Let's talk about some of these issues next.

## 2c. Building a Portfolio

A **portfolio** is simply a grouping of investments, generally from a number of asset categories, into one place. This could be a retirement plan, a brokerage account, or a mixture of mutual funds or exchange-traded funds. When you build a portfolio, you should keep in mind the following:

- The overall weights within your portfolio should align with your financial risk-tolerance score. Weights are just the percentage of your total investment portfolio that is allocated to a specific type of investment.
- Factors such as your risk capacity and time horizon should then be used to moderate your portfolio asset choices.

For example, as the following pie chart shows, if you have a moderate risk tolerance and at least a 10-year time horizon, the weighting of your investment portfolio might be 10% in an online savings account, 30% in a bond, mutual fund or ETF, 50% in stock-based mutual funds and ETFs, and 10% in real estate (not including your home).




When developing your portfolio, you should also consider other risks, such as volatility and inflation.

**Technology: Why Employers Care**

Many employers have an expectation that employees can read and understand graphs and charts like the investment pie chart above. Strong technology skills will allow you to understand these graphs and charts whether they are related to your portfolio or your role at work.

TERM TO KNOW

**Portfolio**

A grouping of investments, generally from a number of asset categories, into one place: a retirement plan, a brokerage account, or a mixture of mutual funds or exchange-traded funds.

## SUMMARY


In this lesson, you learned the **three rules of risk**:

- **Rule 1**. Greater financial risks are associated with higher expected returns.
- **Rule 2**. Financial risk increases as asset liquidity risk increases.
- **Rule 3**. Financial risk increases as marketability risk increases.

If you're looking for higher returns, it's important to **bring the three rules together** and **measure your overall risk tolerance** before investing. Only YOU know what seems safe and what seems chancy given your situation. **Risk tolerance dictates your investment portfolio** because you'll **match your risk-tolerance score to investment alternatives**. Strong problem solving skills can help you determine your risk tolerance. When **building your investment portfolio**, you can try to alleviate some risk by diversifying your funds. Know that you aren't the only one impacted by market volatility and inflation. These are economic drivers that determine how all consumers save, spend, and invest.

Strong technology skills can help you stay on top of your investments. You will often have charts or graphs to review. Doing this work can help you exercise this critical employability skill.




## REFERENCES


Grable, J., and Joo, S. 2001. "A Further Examination of Financial Help-Seeking Behavior." *Journal of Financial Counseling and Planning*, 12(1), 56-66.


## TERMS TO KNOW

**Portfolio**

A grouping of investments, generally from a number of asset categories, into one place: a retirement plan, a brokerage account, or a mixture of mutual funds or exchange traded funds.

**Volatility**

The value of an asset fluctuating up and down or the variability of returns over time.