

INVESTMENT PLANNING COUNSEL'S

Intelligent Investor



Live *your* dream.

Understanding the Risk/Reward Trade-off

Getting a handle on the relationship between risk and reward is one of the biggest challenges for the average investor. Yet it is one of the most important concepts of successful investing.

As investors, we are inundated with information about the next “hot” investment idea. We hear about individuals who scored big on an investment (though we don’t seem to hear about their big losses). We read about investments that assure impressive returns with limited risk. After hearing these claims, we may be tempted to change our investment strategy.

What is Risk?

Keep in mind that each investment change comes with a cost and that cost might be additional risk. Risk refers to the possibility that an investment could decline in value or fail to increase due to swings in the markets. Although all investments are subject to risk, some risks are less obvious than others – especially over the longer term.

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Risk can also mean the possibility that you fail to make enough on your investments to achieve your financial goals. As a result, you may not have enough capital to retire in comfort, send your children to university, or pay for that cottage or trip you dream of. This is a far

more serious consequence than short-term swings in the market.

Having the right investment strategy for you is critical because you have to have the confidence and discipline to maintain it. If you are not convinced that your approach is appropriate, you may jump between ventures seeking the miracle investment. Unfortunately, such an investment does not exist and jumping around may leave you further and further away from your goals.

The Risk/Reward Trade-off

All investments include a risk/return trade-off. Historically, lower-risk investments such as guaranteed investment certificates have offered less potential for long-term growth and investment return, while higher-risk investments such as stocks have presented greater potential for both. By understanding the risk associated with various investment options, you can choose the combination of investments that best matches your risk tolerance and personal circumstances.

Determining how to invest

Where you place your money depends on many personal factors. Most people hate the thought of

losing money but at the same time want to make as much as they can on their investments. Unfortunately, we can't have it all. So, how much risk should you take with your investments? Only you can answer this. You need to create a comfortable balance between risk and return, one that considers your personal circumstances, including:

- **Risk tolerance** — the degree of risk you are comfortable with and can afford to take. Will you sleep at night if your investments experience short-term dips in value? Do you have enough savings for the future to allow you to take some risk now?
- **Investment time horizon** — how long your assets will be invested. Unless you are close to retirement or have a short-term investment time horizon (e.g., paying for tuition next year), you should generally invest for the long term and adopt a long-term perspective. This means understanding that you will endure temporary market drops as the price to pay for higher potential rewards over time. However, if “long” to you means the first drop in the market, you should consider a more conservative investment structure.
- **Overall financial situation and objectives** — how much money you will need to sustain your lifestyle and other commitments during retirement. You will need to consider all of your assets, including real estate, pension and business.

How much risk are you willing to take?

As investment objectives and goals differ from one person to another, the question of how much risk to take is a personal one. To help determine your risk/reward profile, we recommend an approach called the Portfolio Management System. This system involves completing a questionnaire to identify your objectives, risk level, time horizon, etc. Your answers will help determine the best portfolio for the risk level you are willing to assume.

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The next step in the process is to complete an Investment Policy Statement. This document outlines each investment risk and how your strategy will minimize it. We will then choose appropriate investment specialists to administer each component of your portfolio, and agree on a rebalancing strategy and a methodology to regularly review manager performance.

This system provides you with a disciplined method for making future investment decisions, allowing you to maximize potential returns for the risk level you are comfortable with. It helps you to get on, and stay on, a sound path to achieving your financial goals.

For more information about the Portfolio Management System,
please contact us for a consultation.

