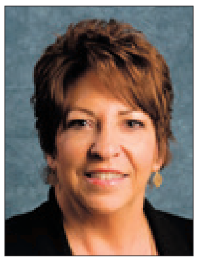
The investment contrast: Full speed ahead or hit the brake?

You're a sensible person, but sometimes you throw caution to the wind.

You are not alone. Most people are both risk-takers and cautious, depending on the activity.



Debra K. Kemmerer

Risk tolerance is one of the basic factors in determining your best investment strategy. Your tolerance can affect both the types of investments you make and how you diversify your portfolio.

So, how do you know how much risk to take with investments? To start, here is a short – and unscientific – quiz to learn more about yourself.

■ **Do you put on the brake** when the traffic light turns yellow or do you step on the gas? If you brake, give yourself one point. If you step on the gas, collect three points.

■ **Do you fill the gas tank** when the needle reaches halfway or do you run a few miles on empty? If you fill the tank halfway, give yourself one point. If you run on empty, score three points.

■ **Do you take the long way** because it's the way you know or will you take a shortcut never taken before? If you take the long way, score one point. If you take the shortcut, give yourself three points.

■ **Do you take the train long** distances or do you fly? If you take the train, give yourself one point. If you fly, collect three points.

Add your points. The maximum is 12; the minimum is 4.

Those with a higher score can accept a relatively great amount of risk and are referred to as risk tolerant. Those who scored low can accept very little risk and are referred to as risk averse.

Many people fall in between the two ends of the spectrum.

RISK IN THE INVESTMENT WORLD

With investments, there are two aspects of risk tolerance:

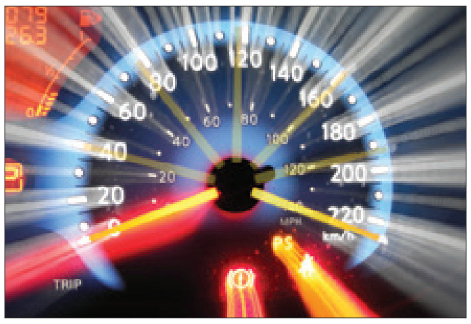
■ **Capacity for risk, or ability to absorb losses**. This is a financial metric. For example, an investor who depends on investments to pay daily expenses has less risk tolerance than someone for whom a loss might just be an inconvenience.

■ **Comfort level with risk.** This is related to the person's personality as well as objectives and goals, life stage, knowledge of investing and investment experience. The basic rule is to only invest as much as you are comfortable with. If you lose sleep worrying about investments, you may have invested too much or too aggressively.

Investors typically fall into three categories of risk tolerance: aggressive (those who are risk tolerant), conservative (risk averse) or moderate (somewhere in between).

WORLD OF UNCERTAINTY

In the investment world, risk means



Stepping on the gas pedal: The more aggressive an investor is, the greater chance to earn a higher return but also the bigger risk to lose the principal.

uncertainty, i.e., the possibility you may lose your investment or that it will yield less than anticipated.

Uncertainty also refers to how much the price of an investment fluctuates. The more the fluctuation, the higher volatility and the greater the uncertainty about the outcome of your investment.

Three factors are key to understanding risk (noting that all investing involves risk, including the potential loss of principal, and there is no assurance any strategy will be successful):

■ **The risk-return tradeoff**. As risk increases, the potential for return also increases. Historically, investments with greater risk tend to provide higher returns, though past results are no guarantee of future returns.

The more aggressive an investor is, the more risk and the greater chance to earn a potentially higher return (assuming any return is earned at all).

Conversely, the more conservative, the less risk and the less potential to earn a high return (though you're also less likely to lose your investment).

■ **The time horizon**. The length of time you plan to stay in a particular vehicle is important.

Generally, the longer your time horizon, the more you may be able to afford to invest more aggressively. This is because you have more time to ride out fluctuations in the hope of getting a greater reward in the future.

■ **The risks inherent in each investment**. Finally, many types of risk can affect an investment. Each investment is subject to all of the general risks associated with that type of investment.

Risk also arises from factors and circumstances specific to a particular company, industry or class of investments.

THE ROLE OF CHANGE

Personal and outside factors may influence your tolerance at any time or over time.

You might expect changes in your feelings about risk when there are increases or decreases in family obligations, major shifts in the economy or other circumstances. In these cases, investors often modify their plan.

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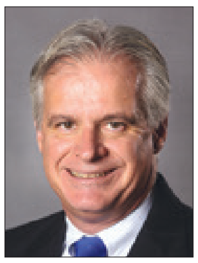
Extent of Fed hike will affect stocks, credit and confidence

The Federal Reserve's Federal Open Market Committee did not raise interest rates in September – not a surprise given that the presidential and congressional elections inevitably cause uncertainty in the markets.



Michael Joyce

Despite maintaining the status quo in September, there is a great deal of consensus that the Fed will raise interest rates at its December meeting.

In 1977, the Federal Reserve's objectives of "maximum employment, stable prices and moderate long-term interest rates" were established. In practice, the mandate is more dual in nature. The Fed is asked to facilitate economic growth while simultaneously controlling inflation.

To fulfill this mandate, then, it is believed by most that interest rates will be raised modestly in December, in a measured way.

Interest rates can and should go up. The question should not be when the Fed will raise rates but rather by how much.

While there have been wage pressures in the U.S. economy, inflation, as measured by the Consumer Price Index, is running right about at the Federal Reserve's target. If that remains between now and December, the Fed likely will raise rates only slightly, which would not have a significant negative impact upon risk assets.

BALANCE SHEET WOES

Another reason the Fed wants to raise rates is to unwind its own balance sheet.

During the unprecedented quantitative easing programs, the Fed bought trillions of dollars of securities (treasuries and mortgage-backed securities), swelling its balance sheet.

There is great concern about what would happen when the Fed started to sell those assets, but, in the end, it opted to hold those securities to maturity.

Once interest rates have normalized, the Fed likely will stop reinvesting the interest in its mortgage-backed securities portfolio and instead will collect interest in cash – thus unwinding the balance sheet.

MOVE FROM STOCKS TO BONDS

What, then, could go wrong with a rate hike?

If interest rates go up more than expected, stocks and other risk assets will be less attractive, relative to less risky, interest-bearing investments.

This would make yields on more secure investments such as treasury securities more competitive with yields on riskier assets.

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Investors would then be more likely to move assets from stocks to bonds, which could send down stock prices.

LOWER VALUATIONS

A higher than expected interest hike also would affect valuations. The value of any company (whether it's Apple, Chipotle or General Electric) is the value of all future cash flows discounted back to the present value.

Stock prices fluctuate daily because no one knows with certainty what companies' future cash flows will be. The perception of those future cash flows is always changing, but then they are discounted back to their present value based, in part, on current interest rates.

Low interest rates result in low discount rates – which then translate to higher valuations for companies. But if interest rates rise, that means the discount rates rise.

So, even if future cash flows are growing, they are discounted at a higher rate, which can result in a lower present-day valuation.

LESS ACCESS TO CREDIT

Additionally, an interest rate hike by the Fed would affect lending markets, making it harder for businesses to borrow and invest money.

This could be problematic since there already is a real lack of confidence and a fear within the business community that another recession could occur.

As it is, small businesses, the backbone of the American economy, have little access to credit, making it difficult for them to expand their businesses. Already cautious about reinvestment, higher interest rates will make companies disinclined to borrow.

The last time the Fed raised interest rates was last December; before then, we had gone nearly six years without a hike. This December is just around the corner. We will know soon enough.

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