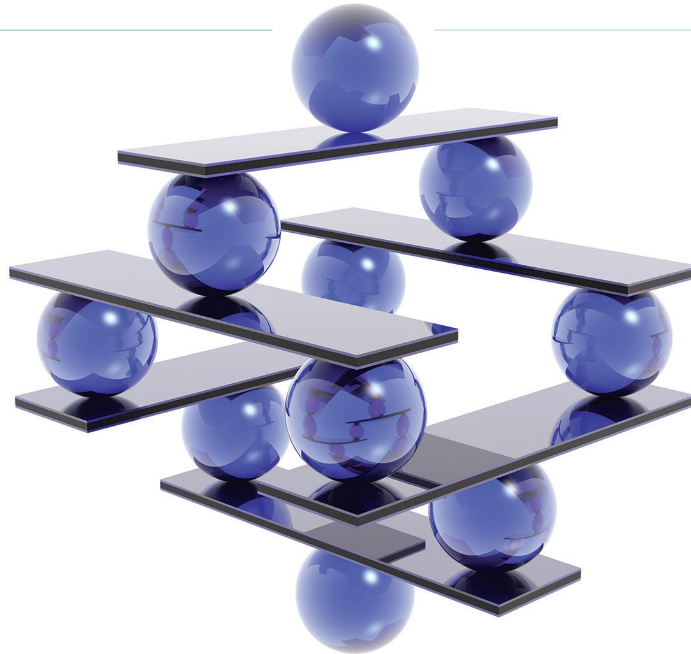

# Calculated risks

*Understanding your tolerance for risk is crucial to mitigating it*

Risk is inherent in investing, and it comes in many forms. Since risk and reward go hand in hand, understanding each major type of risk you face and your ability and willingness to take on risk, generally described as your risk tolerance, is crucial to your success as an investor. Perhaps more important is managing your risk, which is an ongoing process since both your personal circumstances and market conditions are always evolving.

Managing risk in your financial plan requires acknowledging that every choice you make will involve trade-offs. For example, keeping most of your assets in cash will lower your odds of suffering a loss (market risk), but may also increase the chances that you'll outlive your money, what's known as longevity risk. The key is to understand the different types of risk, how each can be mitigated, and finding a middle ground among them that's reasonable and realistic for you.

Here's a look at some of the risks you may face as an investor and ways to manage them:

### Market risk

Perhaps obvious, this is a loss from a declining market. It is an inherent part of investing, but the real risk is how you'll react. If you're exposed to investments outside your comfort zone, you're likely to sell in a down market if your losses are more than you can tolerate. As a result, you may be inclined to abandon your long-term financial plan at or near a market bottom, forgoing any possible subsequent rally – a form of behavioral risk.

### Liquidity risk

If you can't sell an asset when you want and in the quantity you want without a major impact on the price, you have liquidity risk. That quirky mountaintop cabin with a spectacular view may thrill your soul, but it should represent only a small percentage of your overall wealth.

### Longevity risk

No one wants to outlive their money, but this risk can be tricky to handle since we can't know just how long we need our money to last. Closely managing your expenses and how much you're withdrawing from your retirement portfolio are the keys here.

### Inflation risk

Related to longevity risk, this is the possibility that the value of your portfolio won't keep up with inflation. This risk can be mitigated by owning inflation-protected Treasury securities (TIPS), but most investors also will need some exposure to the growth potential that comes with stocks.

### Interest rate risk

Particularly relevant now, this is the risk that rising interest rates will push down the prices of bonds and rate-sensitive stocks such as utilities. Interest rate risk is higher for bonds with longer maturities and

lower for those with shorter maturities. Diversification is your friend here once again.

### Reinvestment risk

The good news about rising interest rates is that they generally reduce reinvestment risk, the possibility that earnings from current bond investments cannot be reinvested at the same or higher rate of return. Holding bonds of varying maturities – what's called a bond "ladder" – can be a useful strategy here.

### Concentration risk

Related to liquidity risk, this is the danger posed by having too much of your money in one investment, asset class or market sector. The simplest remedy is to pick a maximum percentage of your overall portfolio you will allow for any single holding and then trim it back if things get out of line.

### Currency risk

Owning foreign assets exposes you to the risk that changes in currency rates may impact the value of those investments. There are a number of ways to hedge against or otherwise mitigate this risk, so it's not necessarily a reason to avoid opportunities in international investments.

### Political risk

Particularly important with emerging markets but also applicable to developed nations, this is the risk that changes in a country's structure of governance, tax laws or economic policies may impact your investments there. Diversification and closely monitoring your overseas holdings are recommended.

### Sociopolitical risk

A sad reality of modern life is that we – and our investments – are affected by risks posed by terrorism, wars, pandemics and other unexpected events. While it's difficult to anticipate the specific effects of sociopolitical risks, investors need to acknowledge and address them. Maintaining a healthy cash reserve can help ease anxieties here.

## Two primary strategies for risk management

That may seem like a long list, but they can all be countered, at least in part, with two strategies. While there are others, asset allocation and diversification have historically been useful when it comes to helping protect portfolios from various challenges. While they are similar, they are not the same, so let's look at each and how they work together.

Because different types, or classes, of assets respond to changing economic and political conditions in different ways, it's important to have different types in your portfolio. Determining the appropriate asset allocation among stocks, bonds, real estate, commodities, cash and alternative investments will depend on your outlook for the domestic and global economies, inflation, interest rates, corporate profits and other factors as well as the ability to take on risk or loss. The overall goal is to construct a portfolio whose holdings are not highly correlated, meaning that they don't all react to economic events in the same way, which would increase your risk. Asset allocation is a major determinant of long-term investment results, so getting this right can go a long way toward identifying and implementing the appropriate amount of risk on your way to achieving your goals.

Just as spreading your assets among different classes can reduce overall risk, dividing your funds among different investments *within* each class can mitigate the risks associated with a specific company or industry risk. For example, large-cap and small-cap stocks often perform differently at different stages of the economic cycle, so holding both can be beneficial. You can diversify as widely as you wish. For example, you may want to hold stocks representing different sectors of the economy, as well as bonds issued by corporations, the federal government, state and local governments and various municipal agencies. Asset allocation and diversification do not guarantee a profit nor protect against loss.

## Location, location, location

Now that you've selected the assets, make sure you hold them in the right place. We've all heard that location matters in real estate. Truth is, it matters with securities as well. Asset location, different from asset allocation, is an important risk-management strategy, too. Holding certain types of securities in the appropriate types of accounts can make a significant difference in your tax bill. And reducing your tax liability could mean you'll have more money for retirement and investing.

Generally speaking, investors have three types of accounts to choose

from in locating their assets – taxable (e.g., regular brokerage accounts), tax-deferred (e.g., 401(k)s, 403(b)s and IRAs) and tax-exempt (e.g., Roth 401(k)s and Roth IRAs). Income from an investment in a taxable account, however generated, will create a tax liability in the year it is generated. Tax-deferred accounts, which allow investors to hold off on paying taxes until money is withdrawn, are attractive for those who anticipate lower tax brackets in the future. Tax-exempt accounts require that contributions be made with after-tax dollars but then allow investors to avoid further taxation on gains and withdrawals as long as they comply with applicable regulations.

Deciding which account is best for a specific investment will depend in large part on that investment's tax efficiency, or how much of its return is left over after taxes are paid. Investments that generate ordinary income – for example, taxable bonds, high-turnover stock mutual funds or real estate investment trusts – are considered to be relatively tax-inefficient and therefore might best be held in tax-advantaged accounts – either tax-deferred or tax-exempt. Tax-efficient assets – for example municipal bonds, stock index ETFs, or growth stocks held for the long term – may be better candidates for taxable accounts.

While taxes are an important consideration in investment decisions, their impact should be considered only as part of your overall strategy, not as an overriding factor. In other words, don't let the tax tail wag the investment dog. Be sure to consult with your advisor before moving any assets from one type of account to another.

Nothing is static in the market – there's no "set it and forget." Risk management requires that you and your advisor review your holdings regularly and make the adjustments needed to maintain your desired risk profile.

Today's investors can benefit from highly sophisticated tools for assessing different types of risks as well as a much wider array of strategies that can mitigate them. Your advisor has access to resources that were unimaginable a generation ago and that can enable him or her to customize your financial plan to find the right balance of risk and reward, while meeting the multiple challenges you may face as an active investor. In addition to discussing your personal objectives, be sure that your advisor has a complete picture of your financial situation so that your risk profile can be addressed holistically.

## Location matters

While mitigating taxes shouldn't drive your investment strategy, it's important to understand how holding certain types of investments in certain accounts helps create a more tax-efficient portfolio, all things being equal. The general rule is to place your most tax-efficient investments in taxable accounts and your least efficient assets in tax-sheltered ones, but it really depends on your specific needs.

**Taxable accounts***
(e.g., brokerage, bank)

- Tax-free municipal bonds
- Cash and cash alternatives
- Long-term quality holdings
- Low-turnover equity products such as exchange traded funds

**Tax-advantaged accounts****
(e.g., Traditional 401(k)s and IRAs)

- Balanced investments
- High-turnover investments
- Taxable or high-yield bonds
- Real estate investment trusts (REITs)
- Other income-generating investments

**Ideal for consistent lower-growth investments*

*Ideal for low-turnover investments*

The principal of Treasury Inflation-Protected Securities (TIPS) increases with inflation and decreases with deflation, as measured by the Consumer Price Index. At maturity you are paid the adjusted principal or original principal, whichever is greater. Increases in TIPS principal value as a result of inflation adjustments are taxed as capital gains in the year they occur, even though these increases are not realized until the TIPS are sold or mature. Conversely, decreases in the principal amount due to deflation can be used to offset taxable interest income. If sold prior to maturity, an investor will receive the then current market value which may be more or less than original cost.

International investing involves additional risks such as currency fluctuations, differing financial accounting standards, and possible political and economic instability. These risks are greater in emerging markets. Small-cap stocks involve greater risks and are not suitable for all investors. While interest on municipal bonds is generally exempt from federal income tax, it may be subject to the federal alternative minimum tax, or state or local taxes. Profits and losses on federally tax-exempt bonds may be subject to capital gains tax treatment.

Withdrawals from tax-deferred accounts may be subject to income taxes, and prior to age 59½, a 10% federal penalty tax may apply. Unless certain criteria are met, Roth 401(k) and Roth IRA owners must be 59½ or older and have held the IRA for five years before tax-free withdrawals are permitted.

As featured in WORTHWHILE, a quarterly periodical dedicated to serving the clients of Raymond James advisors and aligned advisory firms.

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