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Determining Risk And The Risk Pyramid

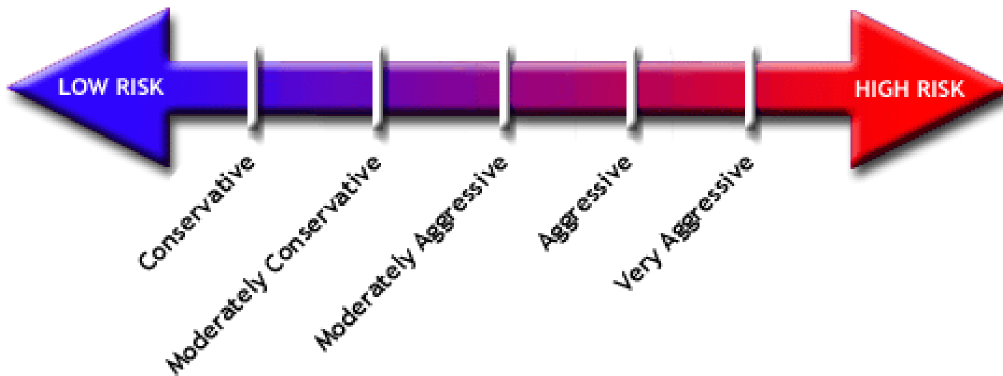
You might be familiar with the risk-reward concept, which states that the higher the risk of a particular investment, the higher the possible return. But many investors do not understand how to determine the risk level their individual portfolios should bear. This article provides a general framework that any investor can use to assess his or her personal risk level and how this level relates to different investments.

Risk-Reward Concept

This is a general concept underlying anything by which a return can be expected. Anytime you invest money into something, there is a risk, whether large or small, that you might not get your money back. In turn, you expect a return, which compensates you for bearing this risk. In theory the higher the risk, the more you should receive for holding the investment, and the lower the risk, the less you should receive.

[When trading or investing, there is risk involved in selecting the actual product you are investing in and deciding when to enter and exit trades. Each step requires a unique strategy to guarantee you are undertaking a comfortable amount of risk.]

For investment securities, we can create a chart with the different types of securities and their associated risk/reward profiles.



Although this chart is by no means scientific, it provides a guideline that investors can use when picking different investments. Located on the upper portion of this chart are investments that have higher risks but might offer investors a higher potential for above-average returns. On the lower portion are much safer investments, but these investments have a lower potential for high returns.

Determining Your Risk Preference

With so many different types of investments to choose from, how does an investor determine how much risk he or she can handle? Every individual is different, and it's hard to create a steadfast model applicable to everyone, but here are two important things you should consider when deciding how much risk to take:

- Time Horizon:

  Before you make any investment, you should always determine the amount of time you have to keep your money invested. If you have $20,000 to invest today but need it in one year for a down payment on a new house, investing the money in higher-risk stocks is not the best strategy. The riskier an investment is, the greater its volatility or price fluctuations. So if your time horizon is relatively short, you may be forced to sell your securities at a significant loss.

With a longer time horizon, investors have more time to recoup any possible losses and are therefore theoretically more tolerant of higher risks. For example, if that $20,000 is meant for a lakeside cottage that you are planning to buy in 10 years, you can invest the money into higher-risk stocks. Why? Because there is more time available to recover any losses and less likelihood of being forced to sell out of the position too early.

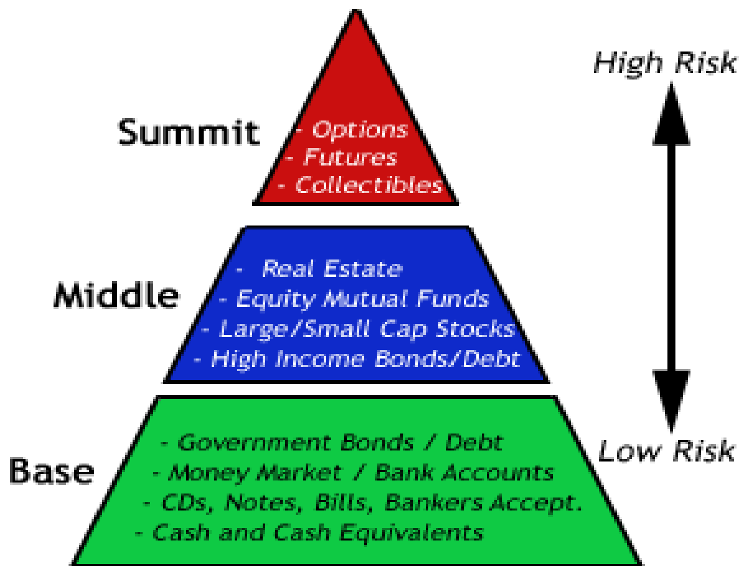
- Bankroll:

  Determining the amount of money you can stand to lose is another important factor of figuring out your risk tolerance. This might not be the most optimistic method of investing; however, it is the most realistic. By investing only money that you can afford to lose or afford to have tied up for some period of time, you won't be pressured to sell off any investments because of panic or liquidity issues.

  The more money you have, the more risk you are able to take. Compare, for instance, a person who has a net worth of $50,000 to another person who has a net worth of $5 million. If both invest $25,000 of their net worth into securities, the person with the lower net worth will be more affected by a decline than the person with the higher net worth. Furthermore, if the investors face a liquid

Investment Risk Pyramid

After deciding how much risk is acceptable in your portfolio by acknowledging your time horizon and bankroll, you can use the risk pyramid approach for balancing your assets. **See below.**



This pyramid can be thought of as an asset allocation tool that investors can use to diversify their portfolio investments according to the risk profile of each security. The pyramid, representing the investor's portfolio, has three distinct tiers:

- Base of the Pyramid – The foundation of the pyramid represents the strongest portion, which supports everything above it. This area should consist of investments that are low in risk and have foreseeable returns. It is the largest area and comprises the bulk of your assets.
- Middle Portion – This area should be made up of medium-risk investments that offer a stable return while still allowing for capital appreciation. Although more risky than the assets creating the base, these investments should still be relatively safe.
- Summit – Reserved specifically for high-risk investments, this is the smallest area of the pyramid (portfolio) and should consist of money you can lose without any serious repercussions. Furthermore, money in the summit should be fairly disposable so that you don't have to sell prematurely in instances where there are capital losses.

The Bottom Line

Not all investors are created equally. While others prefer less risk, some investors prefer even more risk than others who have a larger net worth. This diversity leads to the beauty of the investment pyramid. **Continued…,**

Those who want more risk in their portfolios can increase the size of the summit by decreasing the other two sections, and those wanting less risk can increase the size of the base. The pyramid representing your portfolio should be customized to your risk preference.

It is important for investors to understand the idea of risk and how it applies to them. Making informed investment decisions entails not only researching individual securities but also understanding your own finances and risk profile. To get an estimate of the securities suitable for certain levels of risk tolerance and to maximize returns, investors should have an idea of how much time and money they have to invest and the returns they are seeking.