

## **A Field Guide for Recognizing Risk**

By Rachel Haig | 06-14-10 | 06:00 AM

Potential pitfalls are baked into practically all levels of investing. Some risks are specific to certain investments, while others have broader effects. Risks can originate from a variety of sources, including surprising economic or political events, bubbles, and faltering companies and countries.

The following is an overview of five major types of risks, but it's important to recognize that they do not function in a vacuum. Rather, multiple types of risk are often linked and feed off of each other, magnifying the impact on your investments.

### **1. Market Risk**

Also referred to as volatility, market risk means your investments are subject to largely unpredictable day-to-day fluctuations in trading activity. Investor panic and euphoria can send prices bouncing unpredictably, even if an investment's fundamentals are sound. Often a negative headline will cause a stock's price to slide, whether the issue is temporary or not. Market risk also includes the possibilities of interest rates or currency exchange rates changing.

The "flash crash" is an example of market risk--it remains unclear precisely what caused the market to slide so much initially, but once the decline began, it triggered a chain reaction, including automatic sell orders, which sent stocks further downward.

Market risk becomes a big problem for investors who need to sell their holdings in a down market to raise cash. An asset's price in the short term may not accurately reflect its value based on longer-term fundamentals, but investors without the time, patience, or stomach to ride out a down market often end up locking in their losses by selling at or near the trough.

### **2. Economic Risk**

Economic risk refers to the possibility of an economic shock or weakness weighing on your investments. Economic shock can encompass a number of scenarios and are commonly unexpected, such as an oil shock that creates panic in the stock market. The recent housing crisis is also an example of economic risk--a real estate bubble spread to financials and into the market more broadly. Another example is an investment in a luxury goods company performing poorly because of a recession. Changes in interest rates present another economic risk factor, affecting the costs of borrowing and the value of interest-rate sensitive bonds.

### **3. Country Risk**

There are also country risks, which are caused by political instability or inability to make good on national financial commitments. Even speculation that a country may not be able to meet its obligations can wreak havoc on markets. The current European sovereign debt worries in the PIIGS countries--Portugal, Italy, Ireland, Greece, and Spain--are a prime example. Legislative uncertainty is also a type of country risk. For example, markets were volatile when investors weren't sure how Congress would handle health-care reform. Uncertainty over financial regulatory overhaul is another example.

### **4. Sector Risk**

There is always possible danger that the stocks of many of the companies in one sector (such as health care or technology) will fall in price at the same time because of an event

that affects the entire industry. Overexposure to a sector leaves investors vulnerable to swings and can create losses if the sector turns out to be overheated. The obvious example of sector risk was the dot-com bubble from 2000 to 2002, when the Nasdaq lost 78% of its value.

### **5. Company Risk**

Company risk is more specific than the previous risk types. Company risk is the potential for a company you have invested in to perform poorly and/or become unable to meet its liabilities. Companies that turn out to be operating under false pretenses also fall into this category--think Enron. Many investors have an overexposure to company risk from holding too much of their employer's stock. Even if you have no worries about your company's fate, financial advisors generally recommend that your company's stock make up no more than 10% or 15% of your total portfolio.

#### **What Can You Do?**

Diversify. Risk can't be completely diversified away, but diversification helps you minimize the chance of substantial losses in your portfolio. You can lower your chances of taking a hit by holding varied investments in many different stocks, sectors, and countries. It's easier to minimize company, sector, and country risk than market and economic risk because the latter typically have wider effects, but a diversified portfolio will help protect you over the long term.