Investing Basics: The Risk / Return Tradeoff

One of the basic cornerstones to investing is in understanding the relationship between risk and return. While it is the return side of the equation that investor strive to achieve, it is the risk characteristics that an investor should first understand, and be comfortable with, before pursuing the return.

Risk is present in all investments. Investments in stocks, real estate and mutual funds include risks associated with fluctuation or even loss of principal. Even certificate of deposits (CDs) offer risk as the return may not keep up with the pace of inflation. This is referred to as purchasing power, or inflationary risk.

Typically investors can expect to receive more long-term returns from their investments the more risk they assume. If an investment offers the prospects of a high rate of return, in exchange, the investor must assume a higher level of risk. When an investor takes on a higher level of risk, there must be prospects for a higher rate of return to compensate him for that risk, otherwise, why take the risk?

In investing, you can't have your cake and eat it too. Long-term you cannot have both high levels of return and low levels of risk. If you don’t have the stomach for high levels of risk, taking an inordinate amount of risk, beyond your appetite, may cause indigestion that may cause you to sell that investment without regard to the underlying fundamentals or your long-term investment objectives.

The next time you are selecting an investment, it is prudent to weigh the risks associated with that investment with the potential for return. A basic foundation in developing a portfolio is to clearly define the amount of risk you are willing to assume before selecting an investment vehicle. While risk cannot all together be avoided, it can be managed with the help of a qualified investment professional.

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