There is No Free Lunch

The Latin term “Quid Pro Quo” means “this for that”. These concepts plays out with investment decisions when dealing with risk and return in investing.

Risk is present in all investments. 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. Investments in stocks, real estate and mutual funds include risks associated with fluctuation or even loss of principal.

If an investment offers the prospects of a high rate of return, in return, the investor must assume a higher level of risk to achieve that higher level of return. When an investor takes on a higher level of risk, there must be a higher rate of return to compensate him for that risk, otherwise, why take the risk? Unnecessary risk, without added return, is unwise.

This relationship between risk and reward is transparent in the bond market. Bonds with investment grade ratings (considered BBB or higher) have lower yields than do bonds with non-investment grade bonds. Non-investment grade bonds have the higher prospects for default, thus these issuers need to compensate the investor with a higher yield, i.e. a higher return.

The next time you are selecting an investment, it is prudent to weigh the risks associated with that investment with the potential for return. With a lower risk profile, you must expect a lower rate of return. The concept of diversification is to mitigate risk by having a variation of investments and types in the portfolio. A basic principal in developing a portfolio is to clearly define the amount of risk you are willing to assume before selecting an investment vehicle.

*Adam Smit is the President of Adam Smit Investment Management LLC. He is a registered principal of LPL Financial. Adam has eight years of experience as a registered financial advisor. Adam believes that developing a plan is the first step in helping his client’s pursue their financial goals. His practice emphasizes an investment philosophy of investing in quality while holding for the long-term. Adam can be reached at 715-644-3434. Securities offered through LPL Financial. Member FINRA/SIPC.*