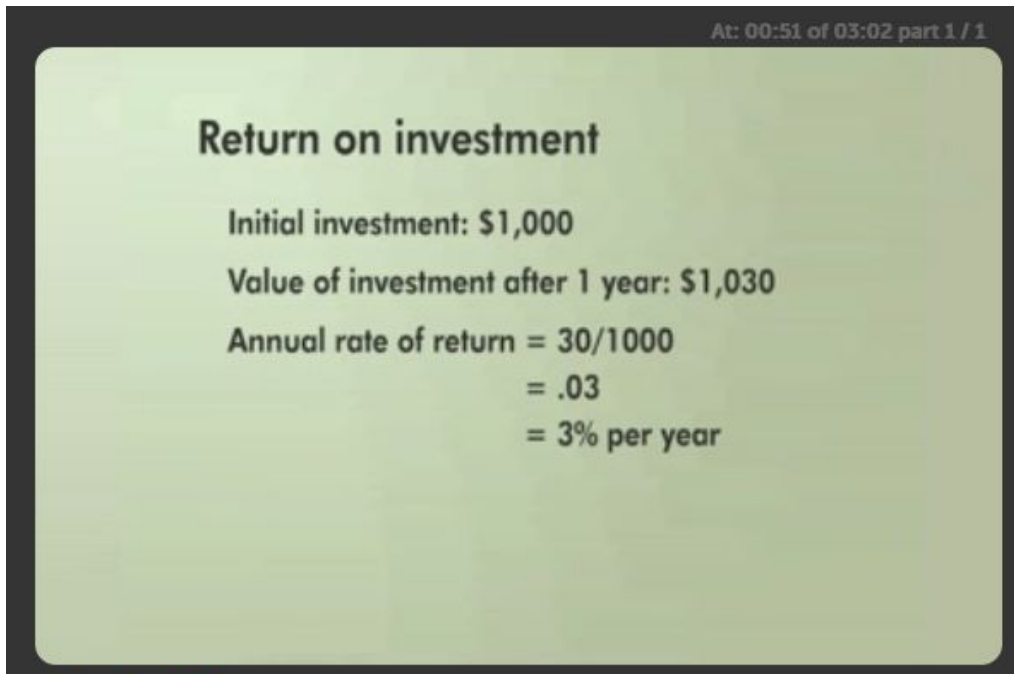


Risk and Return

<http://www.econedlink.org/tool/233/>

Whenever you use your money to make a financial investment in something, there is risk involved. Sometimes that risk is very low, such as with a savings account or a U.S. savings bond. Sometimes that risk is quite large as with stock in a start-up company. In return for bearing that risk, you expect a return on your investment. The higher the risk, the higher the potential return.



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Return on investment

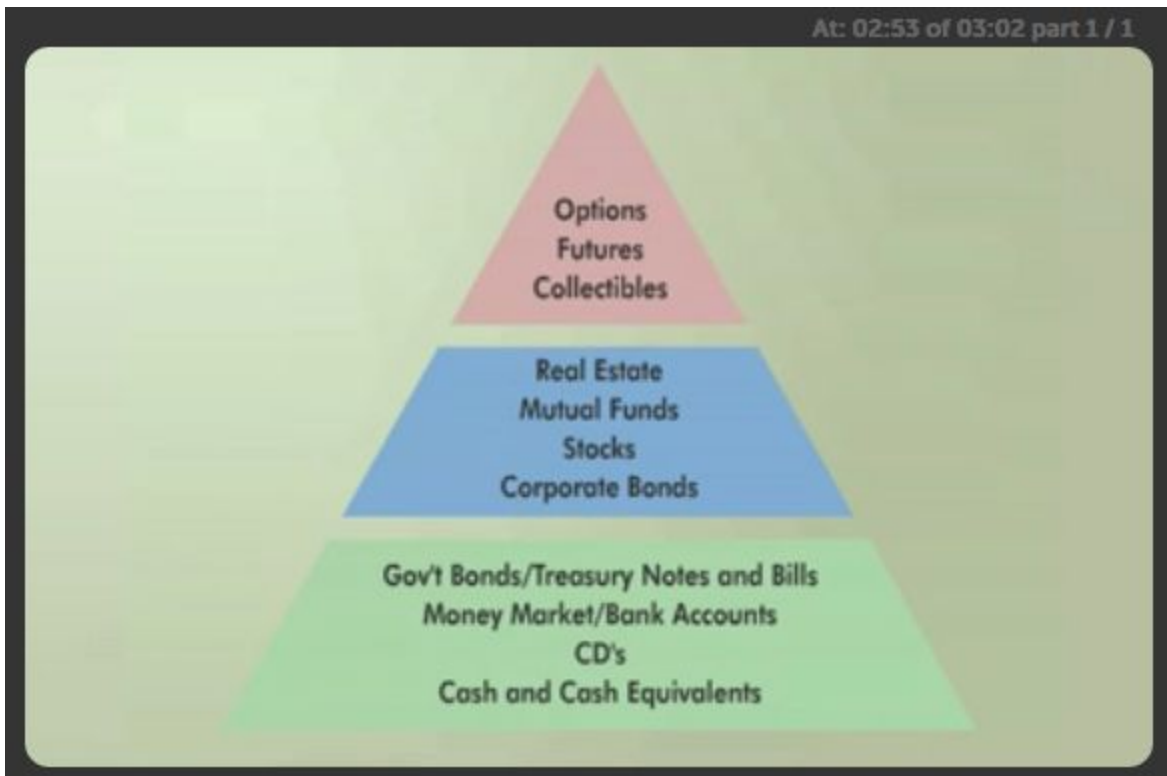
Initial investment: \$1,000

Value of investment after 1 year: \$1,030

Annual rate of return = $30/1000$
= .03
= 3% per year

The return on an investment is calculated as the income earned on the investment divided by the amount of the original investment. The annual rate of return is the income earned on an investment in a year divided by the amount of the original investment. Understanding risk is important to the individual investor. Choosing how much risk to take on depends on many things.

An important factor to consider when determining your risk tolerance is your time horizon. Your time horizon is the amount of time you plan to keep your money invested. If you are close to retirement and are counting on your financial investments to sustain you throughout your remaining years, you will probably want to avoid investments that could lead to a large decline in the value of your portfolio. However, if you are just starting to plan your retirement and have many years to weather ups and downs in the market, you would probably have a higher tolerance for risk.



When choosing financial investments based on risk tolerance, a valuable reference to use is the pyramid of risk and return. The pyramid is a way to help individuals balance their assets. The base of the pyramid is the foundation. This base consists of low-risk financial investments with safe returns. Investments can include government bonds or securities, money market and bank accounts, CD's, treasury notes and bills, and finally cash and cash equivalents such as saving accounts. The middle portion of the pyramid is made up of medium-risk investments that provide a stable return but still allow for capital appreciation. Although more risky than the base, these investments are considered relatively safe. Middle investments can include real estate, mutual funds, stocks, and corporate bonds. It should be noted that risk can vary within a sector as well. Investing in real estate for example, can have varying amounts of risk. The summit portion of the pyramid is reserved for high-risk investments. This is the smallest part of the pyramid and should be comprised of money you can lose without any serious repercussions. It is possible that the money you invest in this portion of the pyramid could generate substantial returns. However, it is very risky and could generate equally substantial losses as well. Investments of this summit include options, futures, and collectibles.

Determining risk is not a scientific process. Every investor is unique and has their own personal opinion of how much risk they are willing to bear.