FUSION
CAPITAL MANAGEMENT

Types of Investment Risks

Interest Rate Risk

Interest rate risk is the possibility that a fixed-rate debt instrument will decline in value as a result of a rise in interest rates. Whenever investors buy securities that offer a fixed rate of return, they are exposing themselves to interest rate risk. This is true for bonds and also for preferred stocks.

Business Risk

Business risk is the measure of risk associated with a particular security. It is also known as unsystematic risk and refers to the risk associated with a specific issuer of a security. Generally speaking, all businesses in the same industry have similar types of business risk. But used more specifically, business risk refers to the possibility that the issuer of a stock or a bond may go bankrupt or be unable to pay the interest or principal in the case of bonds. A common way to avoid unsystematic risk is to diversify - that is, to buy mutual funds, which hold the securities of many different companies.

Credit Risk

This refers to the possibility that a particular bond issuer will not be able to make expected interest rate payments and/or principal repayment. Typically, the higher the credit risk, the higher the interest rate on the bond.

Taxability Risk

This applies to municipal bond offerings, and refers to the risk that a security that was issued with tax-exempt status could potentially lose that status prior to maturity. Since municipal bonds carry a lower interest rate than fully taxable bonds, the bond holders would end up with a lower after-tax yield than originally planned.

Call Risk

Call risk is specific to bond issues and refers to the possibility that a debt security will be called prior to maturity. Call risk usually goes hand in hand with reinvestment risk, discussed below, because the bondholder must find an investment that provides the same level of income for equal risk. Call risk is most prevalent when interest rates are falling, as companies trying to save money will usually redeem bond issues with higher coupons and replace them on the bond market with issues with lower interest rates. In a declining interest rate environment, the investor is usually forced to take on more risk in order to replace the same income stream.

Inflationary Risk

Also known as purchasing power risk, inflationary risk is the chance that the value of an asset or income will be eroded as inflation shrinks the value of a country's currency. Put another way, it is the risk that future inflation will cause the purchasing power of cash flow from an investment to decline. The best way to fight this type of risk is through appreciable investments, such as stocks or convertible bonds, which have a growth component that stays ahead of inflation over the long term.

Liquidity Risk

Liquidity risk refers to the possibility that an investor may not be able to buy or sell an investment as and when desired or in sufficient quantities because opportunities are limited. A good example of liquidity risk is selling real estate. In most cases, it will be difficult to sell a property at any given moment should the need arise, unlike government securities or blue chip stocks.

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Market Risk

Market risk, also called systematic risk, is a risk that will affect all securities in the same manner. In other words, it is caused by some factor that cannot be controlled by diversification. This is an important point to consider when you are recommending mutual funds, which are appealing to investors in large part because they are a quick way to diversify. You must always ask yourself what kind of diversification your client needs.

Reinvestment Risk

In a declining interest rate environment, bondholders who have bonds coming due or being called face the difficult task of investing the proceeds in bond issues with equal or greater interest rates than the redeemed bonds. As a result, they are often forced to purchase securities that do not provide the same level of income, unless they take on more credit or market risk and buy bonds with lower credit ratings. This situation is known as reinvestment risk: it is the risk that falling interest rates will lead to a decline in cash flow from an investment when its principal and interest payments are reinvested at lower rates.

Social/Political / legislative Risk

Risk associated with the possibility of nationalization, unfavorable government action or social changes resulting in a loss of value is called social or political risk. Because the U.S. Congress has the power to change laws affecting securities, any ruling that results in adverse consequences is also known as legislative risk.

Currency/Exchange Rate Risk

Currency or exchange rate risk is a form of risk that arises from the change in price of one currency against another. The constant fluctuations in the foreign currency in which an investment is denominated vis-à-vis one's home currency may add risk to the value of a security.

American investors will need to convert any profits from foreign assets into U.S. dollars. If the dollar is strong, the value of a foreign stock or bond purchased on a foreign exchange will decline. This risk is particularly augmented if the currency of one particular country drops significantly and all of one's investments are in that country's foreign assets. If the dollar is weak, however, the value of the American investor's foreign assets will rise.

Understandably, currency risk is greater for shorter term investments, which do not have time to level off like longer term foreign investments.