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Stock Market Investing Tips, Techniques, and Resources

Investment Risks to Watch Out For

By: www.ProfitableInvestingTips.com

Investing your money always comes with risks. But, leaving your cash in the bank with negative real interest rates means you are accepting a slow and steady decline to your purchasing power. As the stock market has continued its rally in the wake of the Financial Crisis, the chief concern of many investors (and pundits) has been market risk. Have stocks gone too high and too fast? When will be the next crash or correction? There are more investment risks to watch out for and those who are prepared are likely to avoid a lot of pain and suffering along the way.

Important Investment Risks to Watch Out For

Here are nine different risks for investors to be aware of. Each comes with its own level of risk and ways to avoid that particular risk.

1. Market Risk
2. Liquidity Risk
3. Concentration Risk
4. Credit Risk
5. Reinvestment Risk
6. Inflation Risk
7. Horizon Risk
8. Longevity Risk
9. Foreign Investment Risk

Market Risk

Market risk is what most investors worry about. How is the economy going to affect their investments? How will the K-shaped Covid-19 Recession recovery affect their portfolio? Is the VIX telling us that the market is going to crash? The specific market risks include equity prices themselves, interest rates, and currency exchange rates. Interest rate changes have direct effects on bond prices and indirect effects on stock prices. Currency risk has to do with your foreign investments.

Liquidity Risk

One of the reasons that we warn investors about penny stocks is that when you need to sell them there may not be any buyers. In general, the larger the company the more shares they will issue and the more liquid will be their stock. Thus, your investment in a company like Apple, Microsoft, or Amazon.com will less likely to trap you in a stock you cannot get out of than a penny stock that you bought on a tip from a friend and turns out to have been a pump and dump situation.

Concentration Risk

The vast majority of investors do not have the skill set of Warren Buffett who says that if you know which stocks to pick you don't need to diversify your portfolio. For mere mortal investors, diversifying your investments spreads the risk across market sectors, investment types, and even world markets. In fact, when a recession hits and stock prices fall in the growth stock sector they will go up with value stocks in the consumer goods sector.

Credit Risk

This risk applies to corporate bonds or even government bonds. If a company (or country) is not doing well, has had to borrow money by issuing bonds, and now is stressed because interest rates have gone up and they will have to pay a higher rate when they issue bonds again. To make sure that you will get paid for your investment check the credit rating of the company. You should get higher interest rates for companies with low credit. It turns out that if you pool lots of such junk bonds from lots of companies the higher interest rates more than compensate for defaults making such investments more profitable than bonds with higher ratings.

Reinvestment Risk

When you routinely roll over CDs, reinvest corporate bonds, or use a dividend reinvestment plan you incur reinvestment risk when the original investment is not providing a high enough rate of return. Many investors put part of their money into vehicles like US Treasuries to protect the principal but then accept the reinvestment risk of slow loss of purchasing power of that investment vehicle. In general, younger investors accept more risk and older investors who will soon need the proceeds to live on continue with such investments.

Inflation Risk

Inflation is the loss of purchasing power due to the steady decrease in value of a currency. As a rule of thumb, investors in bonds expect to make enough on their interest to stay ahead of inflation by a few percent. That has been difficult in the last few years. Real estate is usually an investment that protects against inflation as property values tend to go up and rents can be increased to compensate for the steadily decreasing value of the currency.

Horizon Risk

Are you investing for retirement in 30 years, to put your children through college in 20 years, or to start a new business in 5 to 10 years? Which is your investment horizon? Each one has a horizon risk. The long term risk is that you will be in conservative investments too early and forego the profit potential of growth stock. The shorter term risk is that you will get caught in a market crash just when you expected to have the money you had accumulated with your investments. As a rule, investors roll over their risky assets into more-conservative ones as the time comes when they will need money for retirement, kids' college education, or investment in the business they have dreamed of starting.

Longevity Risk

When they set up Social Security in the 1930s the average life expectancy was 60 years for men and 64 years for women. Since the age to start receiving benefits was 65, more than half of workers were expected not to live long enough to receive benefits. Today, life expectancy in the USA for a sixty-year-old is 21 more years for a man and 25 more years for a woman. In investing, your longevity risk is that you will outlive your savings, investments, and Social Security. Thus, investors approaching retirement need to balance the risk of a market

downturn versus the risks of exiting growth stocks or stocks that pay healthy dividends just when they will start needing that money.

Foreign Investment Risk

Many times the opportunities of investing offshore outshine those of staying in US markets. And, then a new government comes into power, nationalizes all of the foreign companies and drives the country into a depression. Or, your foreign company does OK but the national currency takes a nosedive and takes your investment with it. Foreign investment risk is why many investors stay at home. But, if you want to diversify offshore the options include US-based funds that track foreign regional investments.

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