The Many Faces of Risk

With every growth opportunity, there is an element of risk; even not investing involves some degree of it. In the end, being aware of the various types of risks will make you a better investor in the long run.

Here is a list of the main types of investment risk that affect mutual funds:
Market risk: The risk that you will lose some or all of your principal. As markets fluctuate, there is always a possibility that the investments hold might be caught in a decline.

Inflation risk: The risk of losing purchasing power. If your investments gain 5% in a year and the cost of living goes up by 2%, you are left with a real return of only 3%.

Interest-rate risk: The risk that rising interest rates will cause your portfolio to decline in value. When interest rates rise, bond prices decline."

Currency risk: The risk that a decline in the exchange rate will reduce your gains (or add to losses). Even if the value of a foreign-currency-denominated investment goes up, a decline in the foreign currency can reduce your returns when they are exchanged back into Canadian dollars.

Credit risk: The risk that the issuer of a bond or other security won't have enough money to make its interest payments or to redeem the bonds for face value when they are due. Securities with a higher risk of default tend to pay higher returns.
Fortunately, not all investments are susceptible to every kind of risk. Equities, for example, are subject to market risk but help protect against inflation risk.
Similarly, fixed-income is susceptible to interest-rate risk, but offers some protection against market risk.
The best defence against risk is a well-diversified portfolio.

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