The world isn't ending…really: it's not!
By Arthur Rottenstein, Registered Securities Principal

Tax professionals, financial planners, investment advisors and anybody in a related field to me has had their hands full in the past few months. What are we so busy doing? Making sense (as best we can) of the economics at hand, and communicating with our clients that the world is not ending, as least as we know it. Every time someone will say "This time it's different!" but it never is. These are cyclical events that take place on a periodic basis in all markets (i.e. stocks, real estate). The question is how we get through these times, and how we deal with risk.

Let's talk about risk. When the term comes up with regard to wealth management, it appears as a number resulting from a series of questions asked but not readily understood. The ultimate observation of risk is the ultimate loss of everything. So: you want to just put it under the mattress you say? Can't lose it that way? Think again…there is more than one definition of risk. In addition to the "mattress definition," one must take into account market risk, inflation risk and loss of purchasing power risk.

Inflation Risk, for many individuals, involves preservation of principal as the primary goal when deciding where to place investment funds. Such investors frequently put much of their money in bank savings account, CD's or T-Bills. While such investments can provide a hedge against market risk, they do not provide much of a hedge against inflation risk. Let's say you had $100 today, put it into the mattress, and one year from now you still have your $100 intact. Good? Not really: if, hypothetically, inflation was 4% last year, your purchasing power of the original $100 is now $96. Multiply that over the course of many years, and the $100 in purchasing power you once had has been reduced by much more.

Market Risk, in simple terms, can be defined as the possibility that downward changes in the market price of an investment will result in a loss of principal for the investor. For many, market risk is most closely associated with the ups and downs of the stock market. Market risk exists for other investments as well. For example, the market price of bonds and other debt investments will move up and down in response to changes in the general level of interest rates, If interest rates rise, bond prices will generally fall. If interest rates decline, bond prices will generally rise. Tangible assets such as real estate and gold, or collectibles such as art or stamps also face market risk.

Credit risk: This is also known as "default risk." The chance that the issuer of a bond or other debt-type instrument will not be able to carry out its contractual obligations. Keeping maturities short, diversifying investments among various companies, and investing in institutions and issues of the highest credit rating are common methods used to help control this type of risk.

Liquidity risk: This risk is the possibility that an investor will not be able to sell or liquidate an asset, without losing a part of the principal, because there is an imbalance between the number of buyers and sellers, or because an asset is not traded very often. Choosing investments traded on an active market, and limiting investments to funds not needed for current expenses are approaches used to help lessen this risk.

Interest rate risk: This is defined as the risk that an increase in the general level of interest rates will cause the market value of existing investments to fall. Generally, this risk applies to bonds and other debt-type instruments, which move opposite to interest rates. As interest rates rise, bond prices tend to fall, and vice versa. One approach to reducing this risk is to stagger or ladder the maturities in the portfolio so that a portion of the portfolio matures periodically, rather than all at the same time. Holding a security until maturity, at which time it is redeemable at full value, is also useful.

Tax risk: This refers to the possibility that a change in tax law, at either the federal, state or local level, will change the tax characteristics of an investment. After such a legislative change, an investment may no longer meet an individual's needs. In some cases, new legislation has included a grandfather clause allowing current investors to continue under the old rules. Making an investment because it's a good investment, rather than focusing on the tax benefits, is an excellent way to help reduce this risk.

So…does all this leave us in a "risky situation?" Not if you have done your homework, and most of all consulted your tax advisor and financial advisor. Remember- surround yourself with the best and the brightest, and be an educated consumer.

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