Don't Be Uncertain About Risk

These days, risk and uncertainty seem to be investors silent partners as they try to manage their investments in volatile markets. Some investors think it's like navigating through uncharted waters, not knowing where the shoals are or what dangers lie ahead. In many cases it's not the known risks but the uncertainties that investors fear most: What you don't know can hurt you.

The difference between risk and uncertainty

For most investors, there is little difference between risk and uncertainty. The two terms are thought to be synonymous, that is, an investment risk is just another way of saying we are uncertain about what the future holds for our investments. But that's not necessarily so.

Economists and financial analysts have boiled the essential difference down to the fact that risk can be assigned a measurable value or "probability of outcome" but uncertainty is a unique form of risk that cannot be calculated or predicted in advance. The insurance industry is always keen to make this distinction when it sets premiums and investors should do the same when building and maintaining their portfolios.

Risks can be assessed as to their investment impact and ranked on a scale of low to high probability of occurring. An uncertainty has no measurable probability of occurring and usually carries unknown financial consequences. Any serious investment uncertainty almost assuredly turns an investor into a speculator. Business and investment risks can be measured usually to anticipate their financial impact and their likelihood of happening. Investors can risk-adjust an investment's present cost and future value to find investments that fit into their own comfort zone where risk and reward are equally balanced.

Learn to recognize your own risk and uncertainty tolerance

Investors need to think about their own risk and uncertainty tolerance when making investment decisions. Too many vague answers to questions about an investment's financial or business prospects should warn investors that its future will be troubled with uncertainty. On the other hand, good answers to tough questions about an investment's prospects can help an investor quantify the risk factors that will influence investment decision-making. In volatile markets this risk awareness can make investing more comfortable by reducing the number of surprises and jolts along the way. Each investor's risk tolerance is different and, as a result, judging acceptable levels of risk or uncertainty will vary by individual. Similarly, risk and uncertainty factors that affect investments will change over time and need to be re-assessed as events and circumstances unfold.

Do your homework

For the most part, an investment's risks and uncertainties are made public in the business media and through its own public documents. Investors just need to know where to look for the details. Every corporation's annual report has a section of its management discussion and analysis devoted to risk factors affecting the company. The auditor's signed statement will alert investors to potential accounting irregularities and assumptions affecting the operations. Additional insight into corporate debt, legal issues and management compensation is often found in the footnotes to the consolidated financial statements. New securities issues, mutual funds and fixed-income investments will have a prospectus that spells out in detail the risks and uncertainties faced by their investors. Finally, brokerages and other financial and securities firms produce analysts' reports and investment assessments of most publically-traded companies and often provide comprehensive information of the risks and rewards investors can expect to face in the future.

Be wary of a too good story

Despite what you read, not all good investment stories have a happy ending. Future projections, estimates and forecasts – the story – all might need a reality check by potential investors. Look out for unsupported assumptions, statistics or data. Past performance can be a guide but no guarantee of future success. Be particularly alert to over-confident predictions that assume political, economic or business developments over which management has no control.

Sleep-protect your investments wherever possible

A proper risk assessment gives investors confidence in their investment decisions. Once uncertainties are identified and risk factors quantified, the investment's potential rewards are risk-adjusted and more realistic as a result. Finding an acceptable level of investment risk can be liberating because surprises and sleepless nights will be kept to a minimum.

Make risk a functional part of investing

Don't hesitate to discuss risk and investment uncertainties with your Raymond James financial advisor who knows your risk tolerance is likely to change over time and your investment strategies and objectives will need to be adjusted accordingly. Risks and uncertainties are to be expected in investing, but when they are known in advance they can be anticipated and unwanted surprises can be kept to a minimum.

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