Wealth Management

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Investment risk and diversification

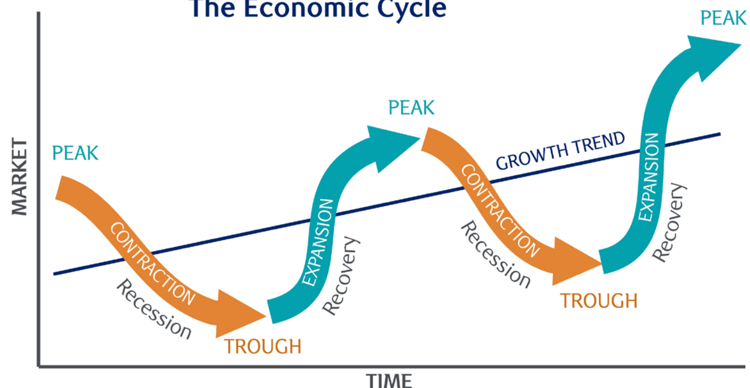
What is investment risk?

Investment risk refers to the potential for uncertain return or financial loss on an investment. When you buy a security — for example, a stock or a bond — the price (also known as the market value) changes in response to various market conditions.

There are several types of investment risk. **Systematic risk** (also called market risk) is the overall risk of a financial market. Markets are cyclical — they move up and down with economic activity. While the up-and-down pattern is expected, the degree in which markets move up and down is not predictable. If you invest in securities, you will be exposed to market risk.

Unsystematic risk refers to risks that are specific to certain companies. Every company that issues securities is exposed to risk associated with their own operations, the type of business they're in, the geographic region they operate in, and other market conditions.

Return on investment, or investment return, is primarily the change in the value of a security over time. If the value goes up over the time you own it, the return is positive, and you have a profit. If the value goes down over the time you own it, the return is negative, and you have a loss. Profit and loss are realized when a security is sold. Price movement up and down while you hold the security is normal and to be expected. If you receive interest or dividends from a security, this income may increase your profit or reduce your loss.



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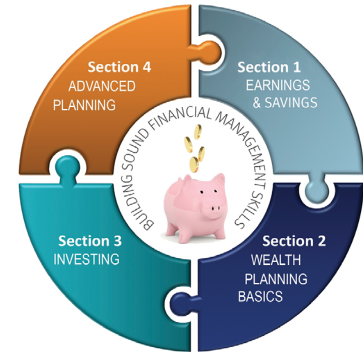
Some of these risks include:

- **Business risk:** The operating risk of a company. The more volatile the company's operating profit, the greater the business risk to the investor.
- **Reinvestment risk:** The ability of an investor to find an investment in the future, when their current investment matures or is sold, with similar risk and return characteristics.
- **Interest rate risk:** The potential for a change in interest rates to affect the value of the security. When interest rates rise, the value of a fixed-income investment will go down.
- **Inflation risk:** The risk that the cost of goods going up over time will reduce the value of an investment and the return on investment.
- **Marketability risk:** The availability of buyers and sellers in an open market. When there are many investors buying securities, an investor selling a position will likely be matched with a buyer and the transaction will settle quickly. If there are few or no buyers, a seller may be forced to hold their position longer or sell at a lower price.
- **Liquidity risk:** How easily and quickly an investment can be sold or converted to cash.
- **Exchange rate risk:** The risk that while investing in a foreign market, fluctuations in the exchange rate cause the value of your investment, in Canadian dollar terms, to go up or down.
- **Default risk:** The potential for a bond issuer to not make interest payments on time or not pay back principal in full.
- **Political risk:** Changes in a country's government or policies that could cause instability and affect the value of securities or markets.



Diversification

Every investment carries some degree of risk. **Diversification** is a strategy to manage investment risk. By investing in a variety of securities, with different characteristics, an investor spreads their risk. Spreading risk means you're exposed to smaller amounts of different types of risk, rather than being fully exposed to one type.

Investors can diversify *by* asset class, which means choosing the mix of cash, fixed income and equities in their investment portfolio. Investors can also diversify *within* an asset class, which means choosing securities from different types of companies, operating in different industries or regions, or by using investment funds that hold many positions.

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