Understanding Risk and Return: The Roller Coaster Ride of Investing

Date : March 2, 2012

What’s the difference between investing your money and stashing it beneath your mattress? Rather than five $20 bills that become a little frayed and weathered over time in your bedroom, when invested, that same $100 might quickly grow to $150 – or it might lose value and dwindle to $75.

It is important to understand the key elements of an investment before digging out those $20 bills and putting them into stocks, bonds or some other means of potentially growing your money. Concepts to think about include risk, return, the effects of inflation on an investor’s return and what is involved in a so-called “risk-free” return, according to Mark McLennon, vice president of Investment Advisory Services with Northwestern Mutual, a financial security company based in Milwaukee, Wisc. “When people talk about risk in the stock market, some of them think about danger or uncertainty,” says McLennon. “But when it comes to investing, the risk can be quantified, or measured, based on historical trends.”

A quantifiable risk isn’t the same as a guarantee, since unanticipated events ranging from technological advances to a sudden shift in the economy can still throw a curveball into how your investment performs. Even so, risk measurement may be able to help an investor to plan his or her strategy, says McLennon.

More Risk, Greater Return — Usually

The holy grail of investing is return, or the profit that a person hopes to make from his investment. The ROI, or return on investment, is usually related to the degree of risk involved, and can be calculated by dividing the investor’s profit — the gain from the investment minus its cost — by the cost of the investment. The result is expressed as a percentage or a ratio. For example, someone who makes $25 on a $100 investment would have a 25% ROI.

“Typically, if there is more risk, an investor expects a larger return over time,” McLennon notes. “You can have different kinds of return, like growth in value or a rise in the price of a stock. Return can also refer to the interest or dividends associated with the investment.”

ROI was an important concept for Kunal Kochar, a 17-year-old senior at Neuqua Valley High School in Naperville, Ill., who was on a team that turned $100,000 of virtual investments into more than $171,640.60 in 14 weeks last year, taking first place in the national 2011 Securities Industry and Financial Markets Association (SIFMA) Foundation Stock Market Game.

The annual SIFMA competition lets students use the Internet and other research and news updates during a 14-week period to decide on their investments. “I’ve actually invested before, and my personal strategy is to buy and hold [the stocks I purchase],” Kochar says. “But the nature of the competition meant that we probably wouldn’t have achieved winning results without taking on a lot of risk.”

Kochar says the team “looked at a lot of things, including getting the greatest ROI in a short period of time.” Among other sources, they used *Barron’s* (financial magazine), Bloomberg (business and financial news) and analysts’ opinions to make their investment decisions. “At school, we’d sit at the computer during lunch to check our picks, and then we’d run right home after school to check closing prices.”

Before making their initial investments or switching to other stocks, the team considered issues like past performance, and technical factors like price-to-earnings ratios (a measure of the price paid for a share of stock relative to the annual net income or profit earned by the firm per share) and other ratios that can be used to compare companies’ stock prices for value.

Beware of Inflation

For cautious investors, putting their money into short-term notes guaranteed by the U.S., is considered to be just about risk-free, says McLennon. The tradeoff, of course, is a lower return. “Three-month treasury bills, for example, currently pay an annualized yield of about 8¢ to 10¢ on every $100 of face value. So people should consider both the risk-free return, and the premium, or rate they’re getting for taking on risk.”

Return can’t be considered as a stand-alone concept, he adds. Inflation, or the rise in general prices, can reduce the real rate of return. Inflation is a rise in prices in a given area over a period of time. For example, soda that costs $1.50 today in the U.S. was at one time priced at 5¢. This is an important consideration in investing. “If your return on investment doesn’t at least keep pace with inflation, you’re actually losing money,” McLennon notes. “So the real rate of return is the unadjusted ROI, less the rate of inflation.” For example, an investment that has a nominal, or unadjusted ROI of 4% during a time when inflation is 5%, would actually suffer a 1% loss.

“I was fairly familiar with risk-reward concepts [because] I’ve been tracking stocks since I was young,” says Brad Stimple, 18, a senior on the first-place Neuqua Valley High School stock market team. “It was a real roller-coaster ride. We started off poorly, with a 20% portfolio loss at one point. But we polished our strategy and, in the end, it worked out. Some of the lessons we learned in the stock market competition can also be applied to our personal lives. In both, you have to find your own balance of risks and rewards. It’s something to think about.”

Want to comment on this story? Answer one or more of these questions to start the conversation:

What is a quantifiable risk?

What is a key factor that can threaten your rate of return?

Have you ever invested in stocks or other types of investments? If so, what was your experience?

Related Links

- KWHS: What Are the Different Investment Choices: From Condos, to Gold, to Just Plain Cash
- KWHS: The Investor Lifecycle: Changing Priorities, Changing Portfolios
- Financial Rate Information and Financial Education
- KWHS: Inflation: What It is, Where It Comes from and How It Can Bite You
- Resource Investing News
- New York Stock Exchange
- Real Estate Investing
- Securities and Exchange Commission: Your Investment Options
- New York Times Topics: Investments
- The Future Investor Clubs of America