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Financial Connections
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Understanding and Dealing with Financial Risk

Risk is a fact of life
Do you wake up in a cold sweat every time the stock market dips? If you are on the verge of panic, take hold of yourself. Risk is an integral part of life and so is learning to manage it. Here are some facts that may help you to understand risk and how to control it in your financial life.

Essential components of risk
High risk is related to both high probability and significant consequences. The probability that you will step on a crack today is high but the consequences are low. On the other hand, the likelihood that you will be hit by lightning today is low but the consequences could be great. Great risks link high probability with significant negative consequences. For example, an investment in any single, unproven stock might yield a great return, but there is also a high probability of significant loss. Note that high risk is not coupled with the probability of a great return but a great loss. A great return is possible but *not* probable.

Risk-reward principle—not all it seems
If you believe that high risk is essential to great rewards, you may be right. But if you believe that high risk is the key to great rewards you are wrong. Undertaking high risks can simply be foolish and have no relationship whatever to big rewards. For example, investing in unseen and potentially worthless real estate can be very foolhardy, with little relationship to any possibility of great reward.

Risk is relative, not absolute
Investment risk is not as absolute as it is frequently considered to be. It is related to time and breadth. For instance, common stocks are not necessarily riskier than savings accounts. Savings accounts are very safe in the short term, because you are sure of receiving your principal and interest. But in the long term, savings account earnings seldom exceed increases in the cost of living by more than a percentage point. A broad-based stock fund, on the other hand, may suffer significant losses of principal and interest in the short term, but its value over long periods of time will likely exceed increases in the cost of living by six to eight percentage points. When it comes to stocks, only length and breadth together help reduce the risk.

Insuring against risk
Insurance can provide a significant balance to risks associated with property, health, and income. But insurance dollars are most effective when used to insure against risks with moderate probability and significant consequences. You can insure your car against minor scratches, but doing so will require higher premiums for a relatively probable but minor consequence. On the other hand, you can insure your health against a single catastrophic illness, thereby protecting yourself against a potentially costly but relatively improbable event. Better still, you can insure yourself against major medical expenses, which would protect you against a potentially costly and moderately probable event. It is desirable but very difficult for either consumers or insurance companies to insure something that is both probable and costly, like long-term care. In such cases, adequate coverage would require commensurately high premiums.

Controlling investment risk
Controlling investment risk requires a firm purpose, a reasonable approach, and a steady hand. It also requires the avoidance of unnecessary costs and questionable strategies. It should not be conducted as a knee-jerk reaction to sudden economic events but rather as a long-term growth process based on a purposeful allocation and diversification of resources. The ultimate object is to position your investments so as to sustain continual real growth in keeping with your goals, risk-tolerance, and time horizons and without regard to temporary market fluctuations. If you wake up in a cold sweat whenever the market dips, perhaps you need to understand your risks better and establish a strategy that will be more settling and consistent over the long haul. Then you can sleep tight.

Ron Wall
Extension Specialist in Family Economics and Management

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