OKLAHOMA STATE DEPARTMENT OF EDUCATION
CHAMPION EXCELLENCE

Managing Financial Risks

Standard 5

The student will analyze the costs and benefits of saving and investing.

Lesson Objectives

- Discuss the role of risk when saving and investing

Personal Financial Literacy Vocabulary

Diversification: A strategy designed to reduce potential risk by combining a variety of savings and investment tools.

Financial risk: The chance that an individual, business, or government will not be able to return money invested.

Fraud risk: The chance that an investment has been misrepresented.

Inflation risk: The chance that the rate of inflation will exceed the rate of return on an investment.

Market risk: The chance that the value of an investment will go down because of a change in supply and demand.

Introduction

"Trace, I just got this text from a friend in Ohio. He's got a great deal for us and we're guaranteed to make money this year. All we have to do is put $100 in some kind of investment account and we'll have $1,000 in one year. He just gave them his money and we need to do it too."

"What? Not sure that sounds right, Mark."

"But he's a good friend. Really smart, too. It has to be the real deal if he is doing it."

What would you tell Mark? Does it sound like a "real deal" to you?

Lesson

When planning your saving and investment strategies, it is also important to consider the different types of risk you may encounter. You want your money to be safe, but you also want it to be earning enough to cover your future wants and needs. A lot can happen between the time you put your money in your account and the time you start withdrawing it. Those "potential problems" are called risk. Risk is basically uncertainty about the future. When associated with saving and investing, risk becomes the potential of losing some or all of your money. However, you still have risk even if you decide not to save or invest because every decision has costs and benefits.

If thinking about retirement and opening a retirement account, you risk is long-term – meaning there is more time for something to happen. But if you do not save for your retirement, there is the risk that you may not have enough money to pay your bills. If saving for a wedding or a college education, your risk is more short-term. But again, even if you do not save now, the risk is you cannot achieve your dreams or goals. Understanding the different types of risk will help you better manage what happens and protect your financial future.

REMINDER

Inflation risk says the price you pay for goods and services rise faster than the rate of return on your investment.

The following table outlines four specific kinds of risk associated with saving and investing your money.

Risks Associated with Saving and Investing Money

Market Risk	Market risk is the potential that your investment will be worth less tomorrow than it is today because prices or values have dropped. For example, most people buy a house expecting the value to appreciate (the future sales price increases). While that tends to happen most of the time, sometimes it does not. The same problem can happen with investments. That is one reason buying a car is not a good investment. The value of a car decreases as you put more miles on it. Of course, if you keep it long enough, it might become a "classic" and increase in value again — but that is a big risk!
Financial Risk	A financial risk is the potential that the business you invest in goes bankrupt or fails to make a profit. While a private business may lose money and go broke, it cannot happen to the federal government. That explains why some people prefer buying government securities instead of corporate bonds or stocks, even though the rate of return is lower. This kind of risk is also called a business risk.
Inflation Risk	Inflation risk says the price you pay for goods and services rise faster than the rate of return on your investment. For example, if inflation is 5 percent, then you would want to earn more than 5 percent on your investment. Otherwise, you are not keeping up with the inflation rate. If you continually earn less than the inflation rate, you are losing purchasing power with your investment and your money is worth less.
Fraud Risk	Fraud risk is the potential that someone either deceives or tricks you into investing in something where you get nothing in return. While fraud is illegal, there are plenty of people willing to make promises, take your money, and run. Anyone can write a fancy brochure or create a Web site with false information. The best way to protect yourself from investment fraud is to invest with highly regarded, reputable companies.

So, why do people invest when there are so many risks? The answer is rather simple; it is because the potential to make money is greater than the risk of losing it when you make good savings and investment choices.

The basic rule of risk says that you have the potential to earn more when the risk is high, and the potential to earn less when the risk is low. However, that does not mean you should always choose something that is high risk to keep from losing money or something that is low risk to protect it. What it means is that you should always making informed choices, which includes knowing the risk you are taking.

It is impossible to eliminate all risk. That is the reason most financial advisors encourage savers and investors to diversify. Diversification is a process where you invest in different types of financial products and with different kinds of financial providers. Or, as the old saying goes, don't put all your eggs in one basket! Diversifying reduces potential risks having a significant impact on your savings and investing by allowing you to maintain a more consistent pattern of earnings under a variety of circumstances.

Conclusion

Understanding the role of risk is fundamental to understand the basics of saving and investing. While you cannot eliminate all potential risk, you can take steps to reduce the potential of risk having a negative impact on your financial future.

FINAL NOTE: If Trace asked you to put your money in his friend's investment, you should say "no" because it has the potential to be fraud. Generally, anything that sounds too good to be true is not a good choice.

This lesson was written and created by
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Name: ______________________________ Class Period: _____________________________

Managing Financial Risks Review 5.5

Define the following types of risk and give the completed lesson to your teacher to review.

Different Kinds of Financial Risks
Market Risk
Financial Risk
Inflation Risk
Fraud Risk