MODULE:3

UNDERSTANDINGINVESTMENTVEHICLESANDRISK

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UNDERSTANDING INVESTMENT VEHICLES AND RISK

Understanding investment vehicles

The link below provides a list of financial products and their definitions. It a complete glossary of the products available and the risk associated with each one.

https://www.bankofcanada.ca/publications/glossaries/glossary/

If you have any questions regarding these products, please let us know. We will be pleased to answer your questions.

Understanding risk and your risk profile

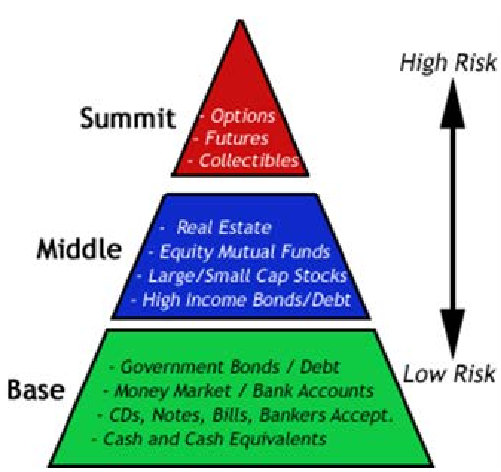
The higher the risk of a particular investment, the higher the possible return.

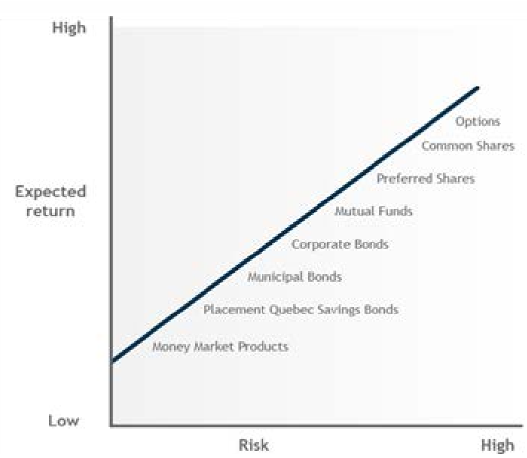
Every individual is different and it’s hard to create a perfect model which is applicable to everyone. However, here are two important things you should consider when deciding how much risk to take:

- Your time horizon – how much time before you plan to use the money you are investing
- The amount of money you can stand to lose

Risk profiles can be divided into three broad categories:

- Risk averse: an investor who, when faced with two investments with a similar expected return (but different risks), will prefer the one with the lower risk
- Risk neutral : an investor who is indifferent to risk when making an investment decision
- Risk tolerant: an investor who has a high propensity to engage in risky investments





Try to associate one of these categories to your personality to help you make better investment decisions and avoid investments that you are not comfortable with.

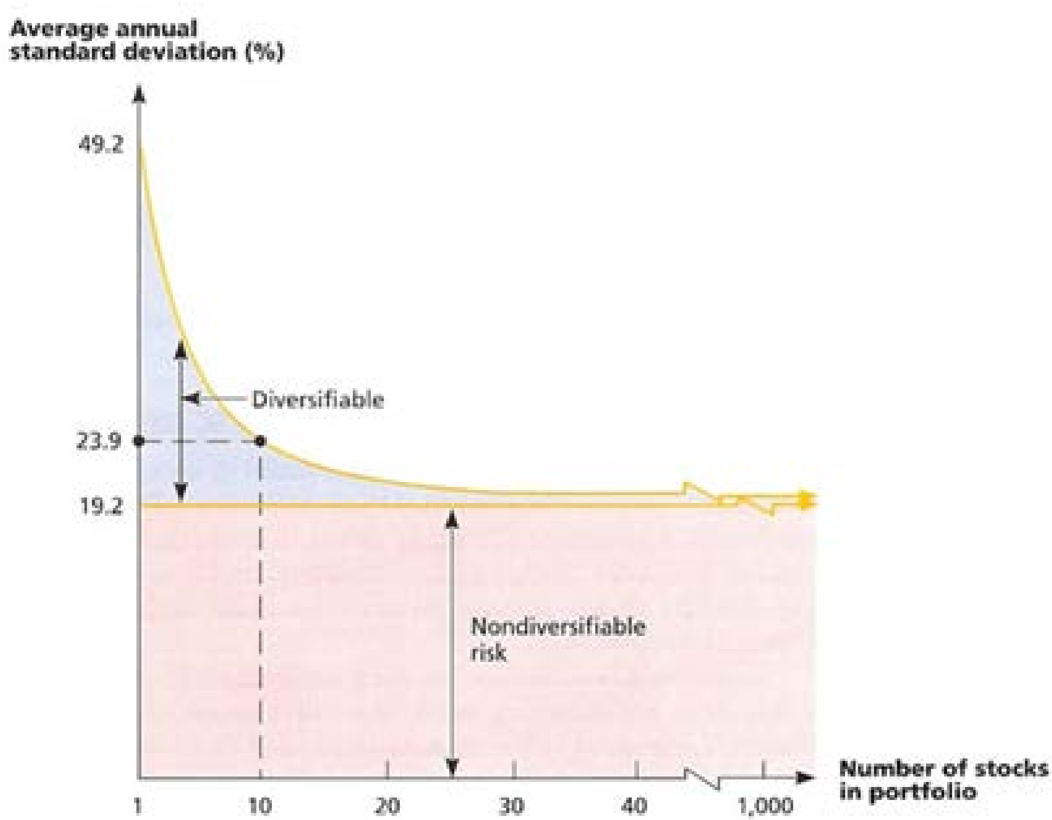
The value of diversification

Diversification is the process of allocating capital in a way that reduces exposure to any one particular asset or risk. A common path towards diversification is to reduce risk or volatility by investing in a variety of assets. You've probably heard the expression "don't put all your eggs in one basket".

Lowering risk and receiving stable returns is the ultimate goal of every investor. It's important to remember that no matter how diversified your portfolio is, risk can never be completely eliminated. There will always be market risk, also called systemic risk. Diversification can help but if there is a major or broad-based marked correction, it will not fully protect you.

Markets tend to behave differently according to various events affecting them. Stocks move in different directions based on a variety of factors including news (for the company specifically, a particular sector, or global events). This is why we buy them in different sectors, industries and/or countries.

The following is a graph showing the theory of diversification. The standard deviation represents risk on the Y axis in relation to the number of stocks in a portfolio. The risk associated with a stock becomes nil as diversification is increased. Diversification will not be achieved if you invest all your "eggs" in the same sector. You must invest in many sectors. Holding 12 diversified investments will reduce market risk. However, if you hold too many investments in your portfolio, you run the risk of over-diversifying, which essentially means reaching the point whereby all your positions are matching each other off and your portfolio goes nowhere.



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