First things First, what you should think about

Before you begin to think about investing your money, you need to think about how you feel about risk. Risk is a part of all investing – it can't be avoided. But peace-of-mind is still possible. The secret is to be aware of the different risks, be aware of how you feel about them and always stay within the level of risk you are comfortable with.

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Whatever you do with money you face risk

Many people don't really think about it, but whatever you do with your money – even if you do nothing – you face risk. Risk is part of every financial decision you make. That's why it's important for you to think carefully about the various kinds of financial risk you face. The one kind of risk everyone knows is the risk of losing your money in the market. But market volatility is just one kind of risk.

When you just leave your money in a savings account, you expose yourself to another kind of risk. Although your money is safe, you risk losing to inflation. If you're getting 2% interest on your money, and inflation is 4%, the value of your savings is declining 2% every year. That's a serious risk over the long run.

Another risk is caused by fluctuations in interest rates. Let's say you put your money in high quality bonds. If interest rates go up, the price of those bonds will fall, even though they are the highest quality. If you want to sell them before they mature, you risk losing some of your capital.

And if you invest in long-term GICs, and interest rates go up, you also lose out. Although the value of your investment is guaranteed, you suffer an opportunity cost. You lose because you're receiving a lower return on your money than what is currently being paid.

So, if risk is an unavoidable fact of financial life, what can you do? Simple. You learn to minimize it and that's the subject of much of this section.

There is one risk free investment that will pay you a great return

You should know that there is one investment you can make that has virtually no risk and that will provide you with a guaranteed high return. Just pay off any expensive credit card debt you might have.

Compare the interest rate your credit card is charging you with the interest rate your bank will charge you for a loan. The difference represents the return you'll earn by borrowing from your bank and paying off your credit card balance.

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Why most people should do much better

They let their emotions rule their actions. The best-laid plans can be sabotaged when emotion gets in the way. Emotion is one of the main reasons the average investor doesn't do better. Especially in today's markets.

You can do everything right, and have a well thought out strategic investment plan in place. But when the market turns against you, as it surely will at some point, if you let your emotions overpower your strategic thinking, you're going to make some bad decisions. Many investors are their own worse enemies. They don't deal with this vital question up front: "How much risk am I willing to tolerate?" They don't think things out beforehand. Then when they're faced with a difficult situation, they're not able to stick to their plans. And they wind up rethinking and remaking decisions under the worst conditions.

They'll watch the markets go down for a few weeks or a few months or even longer. Then, after sticking to their plan through the downturn, they finally lose patience and sell. Occasionally it may turn out to be the right move but usually it's not. In most cases, all they do by selling is lock in their losses. Then they make things even worse.

In typical overreaction after experiencing a loss, they seek safety and put their money in GICs. Then they watch with frustration as the market turns and moves on to higher than ever levels. Not only have they taken an unnecessary loss but they miss out on profits they should have had.
This is a common scenario for many investors. They miss huge potential gains because they make decisions based on emotion and fear rather than on logic and discipline.

You have to have a long-term written plan – and stick to it!
Without an investment plan, you're going to be reacting to daily events, and that's not an effective way to invest. You need a long-term plan that will give you the confidence to ride through the daily news and the inevitable volatility.

And your plan should be in writing. Putting your plan in writing will increase your commitment to it. It will make you feel that you are in control and taking concrete steps toward achieving your goals.

Most important, you have to stick to your plan. And to be able to do that, it's vital that your plan be based on how much risk you can handle. And that means your goals must be compatible with your tolerance for risk.

If your goal is for high rapid growth and your risk tolerance level is low, that's not a compatible situation. And since you're not likely to change your emotional attitude toward risk, you need to change your goal.

How do you feel about risk? Be honest

You can quantify most key factors in investing but you can't quantify the most important one – emotion. You can't measure how you'll react when you're faced with the prospect of loss. Or how you'll react if the loss actually happens.

How you feel about risk is a difficult question and one that can't be answered with any precision. But it's a vital question and one you'll have to deal with.

We all want our money to grow, but the more growth potential an investment has, typically the riskier it will be. That's the risk-reward challenge at the center of just about every investment decision.

You really have to be honest with yourself and realistic about your willingness to tolerate risk. You have to weigh your emotional ability to accept risk against your desire for a specific level of return. You have to find that delicate balance of risk and reward that is right for you. You have to ask yourself . . .

How comfortable would you be watching the value of your investments decline?
Would you be able tolerate large fluctuations in the value of your portfolio if there's a prospect of large returns?

Would you prefer a smaller return on your investments in exchange for less fluctuation in value?

Some people love the action and thrive on the risk and uncertainty. Others lose sleep over it. So what is the right amount of risk for you?

The easy answer is an amount of risk that will allow you to sleep at night. That will let you go through the day without wondering a dozen times how your portfolio is doing.

To arrive at that answer requires some self-examination. There is no magic formula to help you find the right balance. The important thing is for you to be aware and thinking about it.