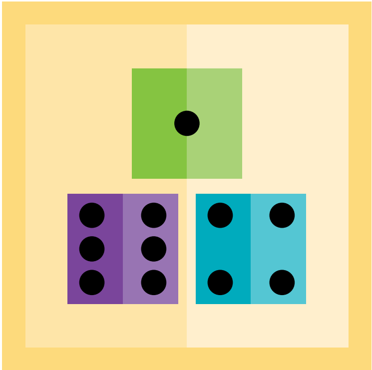
Building **Wealth**

In the Classroom

Interactive Lessons

Lesson 9

Save and **Invest**—Risk and Return



Federal Reserve Bank of Dallas

Instructional Objectives

Students will:

- Explain the relationship between risk and reward.
- Describe different types of financial risk.
- Analyze a saving or investing scenario to identify financial risk.
- Evaluate various financial assets to identify potential risks and rewards.

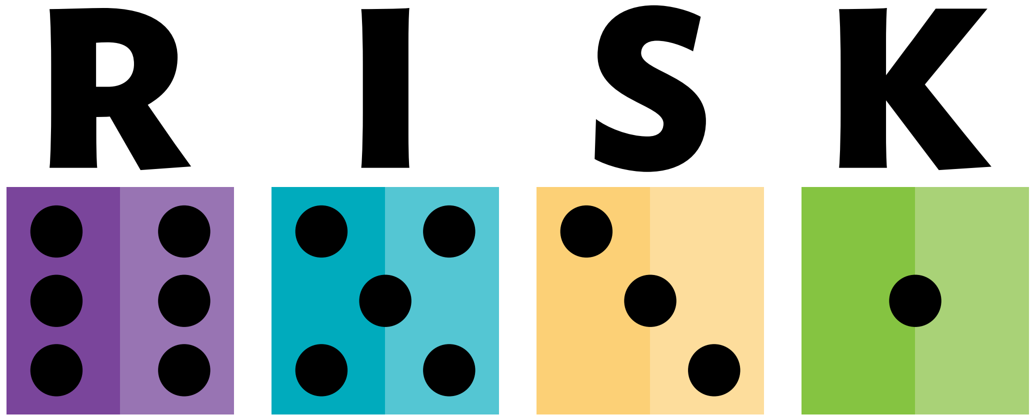
Everyday Risks

Playing sports

Driving a car

Types of Assets

Financial Risks

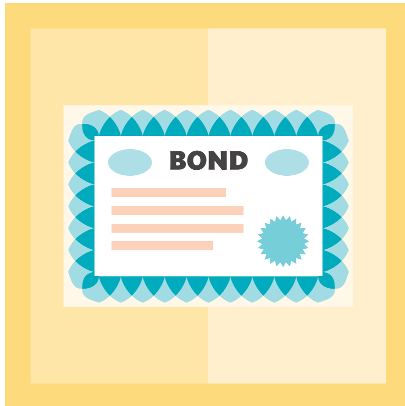


Not all investments make money. Financial risk is the possibility that an asset will fail to produce a return or will lose value over time.

Why might an investment lose money?

Risk of capital loss

When a saver buys an asset hoping for a capital gain, the market price of the asset can fall, resulting in a capital loss.



Risk of default

When a saver loans money or buys a bond, the borrower might not repay the original amount or the promised interest.

Other Investing Risks

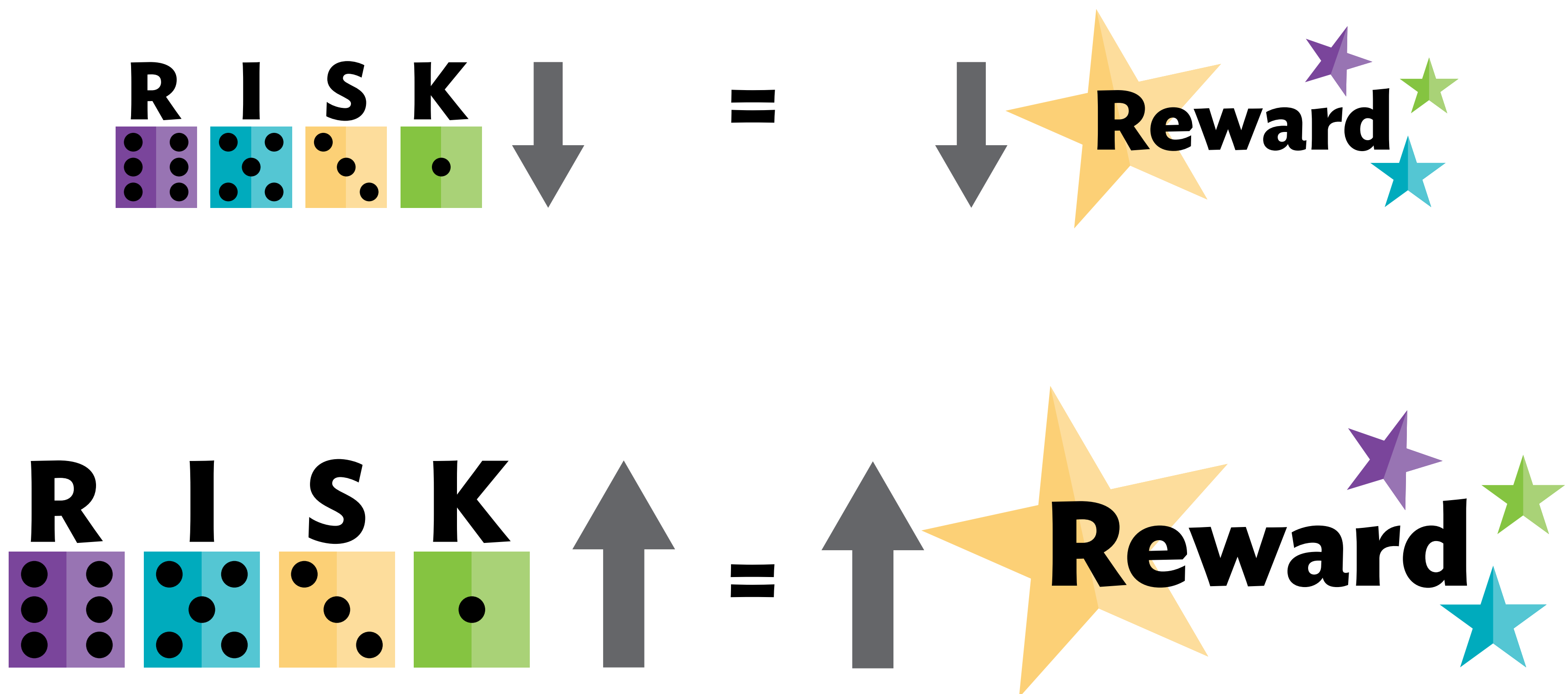
Risk of inflation

When a saver earns a rate of return that is less than the rate of inflation, purchasing power is lost.

Risk of liquidity

When a saver buys an asset for an investment, the asset must be sold to realize the capital gain. Market conditions affect the saver's ability to sell the asset.

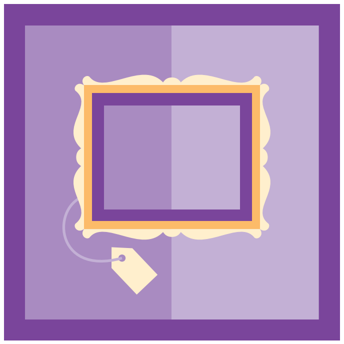
The Risk/Return Relationship



How much risk can you afford to take?

Risk and Return Case Study

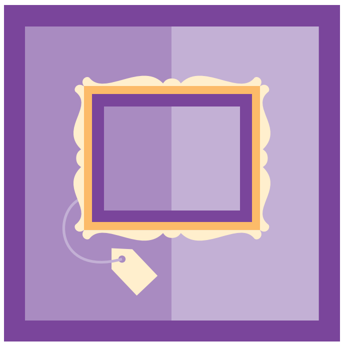
Case 1



Several years ago, Chelsea was given a painting by a famous artist. She planned to keep it as an investment, hoping its value would increase so that she could sell it and make a profit. Several years later, Chelsea had costly emergency surgery, and she did not have enough money in her savings to pay for the procedure. Fortunately, the painting had substantially increased in value, and she decided to sell it. She found a reputable art dealer who told her that the market conditions would make it difficult to sell the painting for its full value in the next six months. Chelsea needed the money immediately, so the art dealer offered to buy the painting at a deep discount.

How would you describe the financial risk that Chelsea faces?

Risk and Return Case Study



Case 1

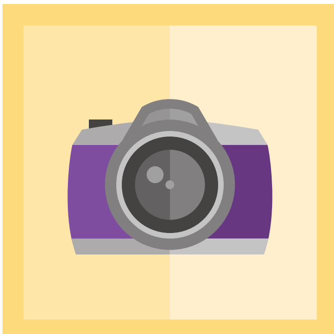
Several years ago, Chelsea was given a painting by a famous artist. She planned to keep it as an investment, hoping its value would increase so that she could sell it and make a profit. Several years later, Chelsea had costly emergency surgery, and she did not have enough money in her savings to pay for the procedure. Fortunately, the painting had substantially increased in value, and she decided to sell it. She found a reputable art dealer who told her that the market conditions would make it difficult to sell the painting for its full value in the next six months. Chelsea needed the money immediately, so the art dealer offered to buy the painting at a deep discount.

How would you describe the financial risk that Chelsea faces?

She cannot sell the painting for its full value as quickly as she needs to do so. Therefore, she faces a liquidity risk.

Risk and Return Case Study

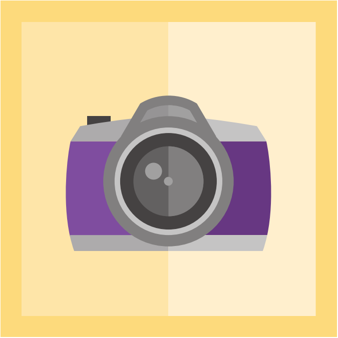
Case 2



Paul's friend Janet had an idea of creating a photography service that went to school functions, such as football games, pep rallies and dances, to take candid pictures. The pictures would be available to purchase the following week. She needed $300 to buy additional equipment and start an advertising campaign, so she asked Paul for a loan. She promised to pay him back the $300 and give him 25 percent of her profits from the first semester. Janet sold a few pictures the first week of school but quit going to events to take pictures. She can't repay the loan, and there are no profits. Paul lost $300.

How would you describe the financial risk Paul faces?

Risk and Return Case Study



Case 2

Paul's friend Janet had an idea of creating a photography service that went to school functions, such as football games, pep rallies and dances, to take candid pictures. The pictures would be available to purchase the following week. She needed $300 to buy additional equipment and start an advertising campaign, so she asked Paul for a loan. She promised to pay him back the $300 and give him 25 percent of her profits from the first semester. Janet sold a few pictures the first week of school but quit going to events to take pictures. She can't repay the loan, and there are no profits. Paul lost $300.

How would you describe the financial risk Paul faces?

Paul has lost the money because Janet cannot repay him, so he faces the risk of her default.

Risk and Return Case Study

Case 3

Mike spent every summer during high school mowing yards. He saved the money to pay for his living expenses during college. He decided to keep his money in certificates of deposit at his bank. The deposits earned 3 percent interest. He anticipated that he would have enough money for two years of living expenses. When he got to his college town, he realized that food and rent, along with many other prices, were much higher than he had originally estimated. Prices rose faster than the value of his savings.

How would you describe the financial risk Mike faces?

Risk and Return Case Study

Case 3

Mike spent every summer during high school mowing yards. He saved the money to pay for his living expenses during college. He decided to keep his money in certificates of deposit at his bank. The deposits earned 3 percent interest. He anticipated that he would have enough money for two years of living expenses. When he got to his college town, he realized that food and rent, along with many other prices, were much higher than he had originally estimated. Prices rose faster than the value of his savings.

How would you describe the financial risk Mike faces?

Since prices have risen and Mike has lost purchasing power, he faces the risk of inflation.

Risk and Return Case Study

Case 4

Jennifer decided to buy $1,000 worth of stock in a company that makes very popular products. She believed that the company would grow and be profitable for the next several years. Several months later, she found out that the company lost a major case in court and will no longer be able to sell its most popular product. Jennifer decided to sell all her stock. When she called her stockbroker, she found out that her shares were worth $400.

How would you describe the financial risk Jennifer faces?

Risk and Return Case Study

Case 4

Jennifer decided to buy $1,000 worth of stock in a company that makes very popular products. She believed that the company would grow and be profitable for the next several years. Several months later, she found out that the company lost a major case in court and will no longer be able to sell its most popular product. Jennifer decided to sell all her stock. When she called her stockbroker, she found out that her shares were worth $400.

How would you describe the financial risk Jennifer faces?

The stock has declined in value, so if Jennifer sells the shares today, she will face the risk of a capital loss.

Why take the risks?

Why take the risks?

Assessment