



Understanding Risk in Your Portfolio

The relationship between risk and return is one of the most fundamental relationships in investment management. Risk and return are directly proportional, and as an investor it is critical that you understand the role of risk in your portfolio. As you require a progressively larger rate of return, you are accepting the risk of withstanding the same rate of drawdown at any point in time.

Risk is an unavoidable component of investing – understanding not only how to manage risk but how to leverage it can help you enhance your results as you work with your financial adviser and your investment management team to develop appropriate financial planning objectives.

Determining your risk tolerance

With a dizzying array of investment options to choose from, how do you know how much risk you can afford to take in your portfolio? The appetite for risk varies significantly from person to person, and personality can play a strong role in shaping attitudes toward risk. However, it is critical that your decisions about risk be informed by certain hard facts. There are two principal factors that you should consider when deciding how much risk to take.

Time horizon

Before making any investment, you should determine the period of time over which the funds will be invested. If you have \$50,000 to invest today but would like to use the money to buy a house next year, your investment strategy will be quite different from that which you would pursue if you were investing the money for your retirement in 25 years. If your time horizon is relatively short, you should avoid riskier investments that exhibit higher volatility. When your time horizon is longer, you have more time to recoup any short-term losses and you can afford to assume more risk in order to seek higher returns.

The size of your investment

The amount of money you have available to invest, or perhaps more accurately, the amount of invested funds as a proportion of your overall net worth, also strongly influences your risk tolerance. Understanding this proportion can help you determine what investment losses you can afford to bear. While not the most optimistic approach to investing, this is a realistic way to assess your financial position. If you invest money that you will not need for some time, you will be able to make investment decisions based on fundamental characteristics rather than the need for liquidity, and you will be less likely to panic and make emotional decisions during bear markets. The more money you have, the more risk you are able to take.

Other Factors

While the time horizon and size of your investment are the most influential factors in determining what level of risk is right for you, other factors also have a considerable impact on your personal risk profile. Your personal financial situation, future earning potential, family circumstances, tax position and investment objectives all factor into your risk budgeting decision, as does the current composition of your portfolio.

The return you need to generate from invested assets also plays an extremely prominent role in determining what level of risk is appropriate for you. For example, an investor who is focused on capital appreciation and requires an annual return of 10% to meet his or her growth objectives will need to allocate a larger percentage of the portfolio toward high growth equity investments, which are naturally higher in risk. A retiree who seeks a lower return but significant income will make a large allocation to low volatility fixed income investments. It is critical to understand what level of risk is necessary to achieve your investment objectives. Developing appropriate and realistic expectations is integral to a successful investment program.

How do you define risk?

Most investors, if asked, would probably define risk as the chance that they will see the value of their investments decline and they will sustain permanent losses. But investment professionals rely on a number of quantitative measures to define and measure risk. By understanding these quantitative measures, you will gain a tool that can help you better understand risk and inform your investment decisions.

Volatility is the tendency of markets or securities to move up or down (sometimes dramatically) over a short period of time. The most common measure of volatility is a statistical term known as **standard deviation**. The standard deviation of an investment indicates how far a security or fund's returns have varied from the average annual total return. A lower standard deviation indicates lower volatility. For example, fixed income is typically considered to carry less risk than equity. The Lehman Brother's Aggregate Bond Index, a proxy for the bond market, has a 10-year standard deviation of 3.8%, while the S & P 500, a common proxy for the stock market, has a standard deviation of 15.6% for the same period. When you evaluate a mutual fund or investment portfolio, you can compare the portfolio's standard deviation to that of an applicable benchmark index to understand the relative volatility of the return, or its risk.

Beta is another measure that investment professionals use to understand volatility. Using statistical analysis, this measure can be calculated for an individual security, a portfolio or a fund. Beta measures volatility relative to the market, which by definition has a beta of 1. A stock or fund that is more volatile than the market will have a beta greater than 1, while a stock or fund that is less volatile than the overall market will have a beta of less than 1. A high beta indicates greater risk, as well as the potential for a greater rate of return, while a low beta indicates the converse. Looking at the beta is yet another way to determine whether an investment is consistent with the level of risk that you are willing to assume.

Work with your financial adviser to determine what's right for you

Before you meet with your financial adviser to discuss your personal investment objectives, think carefully about your feelings toward risk as well as your financial needs. Bearing in mind the relationship between risk and return and your understanding of the role of risk in investment management, you need to decide what is comfortable for you while maintaining realistic expectations.

A frank discussion about risk with your financial adviser is essential in developing a financial plan that will help you reach your goals.

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