Is there a risk-reward tradeoff? What does it mean for my investments?

Understanding the risks involved in various investments, minimizing them and generating higher returns is the key to successful investment.

The risk-reward tradeoff is the balance that an investor has to achieve between the risk involved in an investment and its potential returns.

It is hence the process of deciding how much risk you are ready to take in order to achieve the desired rewards. While determining this, it is important to note that every investment has some risk associated with it; only the level of risk differs. Experts are of the opinion that the higher the risk the higher the returns, and vice versa.

Investments like stocks and junk bonds often fall in the high risk category, while low risk investment options include fixed deposits and savings certificates. Instruments like mutual funds and corporate bonds are included in the moderate risk category.

How to determine risk benefit

Determining the amount the risk you can take depends on the type of investor you are. If your objective is to earn decent returns without taking high risk, you should prefer investing in products like fixed deposits, government bonds, etc. Similarly, if you are nearing retirement, your investment portfolio should contain as little risk as possible. Instruments to be considered can be fixed-income products like public provident fund (PPF), monthly income plans, etc. Conversely, if you are ready to take higher risk, there are several products that have the potential to provide high returns. These include stocks, commodities, junk bonds, etc.

Hence, it is first important to determine the level of risk you are ready to take, and then select the appropriate instruments. This will ensure that your goals are not only met in time, but are also in accordance to your risk profile.