Measuring Devices For Investment Risk

Knowing how to measure investment risk can help you establish a portfolio you can be comfortable with. Any measure of risk must include a time horizon, because an investment that's risky in the short run often may be much safer in the long run—and vice versa.

As a retirement investor, you need a portfolio that can outpace long-term inflation without incurring more short-term volatility than you can comfortably handle.

Check out the following tools for gauging the risk of the funds in your portfolio. They'll tell you how a fund has performed in the past compared to the market as a whole, and how volatile you can expect it to be in the short term.

Beta:
Measures a fund's past sensitivity to market movements. The overall stock market has a beta of 1. A beta of 1.25 indicates a fund has been 25% more volatile than the market; a beta of 0.75, that it has been 25% less volatile.

What it means:
A high beta suggests that in a rising market, a fund may outperform the overall market; but in a falling market, it may lose value faster. A low beta suggests that in a rising market, a fund may not rise as much as the market; but in a falling market, it may retain more of its value.

R-Squared:
Measures how closely a fund's past performance has tracked the performance of a benchmark index, such as the Standard & Poor's 500 Index.

This tells you how much of the fund's past performance, good or bad, may be attributable to the performance of the overall market. An R-squared valued of 0 shows there has been no correlation between the fund's past performance and the benchmark; an R-squared value of 100 indicates perfect correlation between the two.

What it means:
Comparing the R-squared numbers of your mutual fund holdings tells you how likely they are to move in lock-step, based on their past performance. Ideally, you want to own funds that behave differently from one another. R-squared is a measure that may help you assemble a well-diversified portfolio.

Standard Deviation:
A fund's average annual return is just that: an average, which includes up years and down years. Standard deviation measures the range of highs and lows compared with the fund's average performance, usually over a 36-month period. (An investment with an unvarying rate of return, such as a fixed-rate bank account, would have a standard deviation of zero.) The higher a fund's standard deviation, the more volatile it is likely to be.

What it means:
Standard deviation shows how much volatility you can expect. When a fund's standard deviation is much higher than its average annual return, it tells you that in the past, its best annual performance has been much higher than its average annual performance—and its worst annual performance much lower. If you prefer a smoother ride, you're likely to be more comfortable with a fund with a lower standard deviation.

For good measure
To find out more about risk-measurement tools and how to use them, go to financial Web sites like **smartmoney.com, morningstar.com,** and **mfea.com** (the Mutual Fund Investor Center).