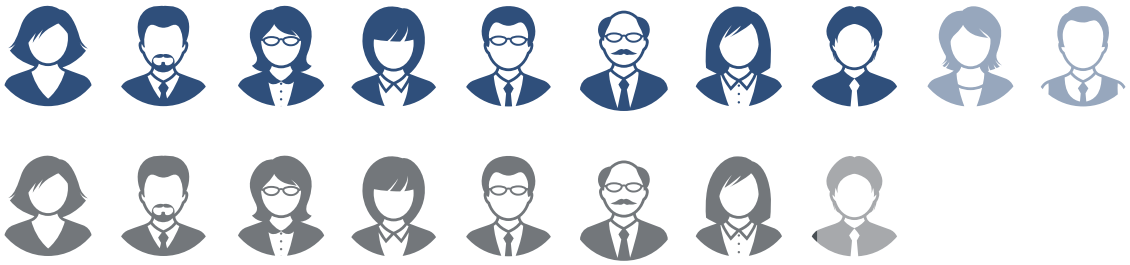
3 Principles for Understanding Risk

"Real knowledge is to know the extent of one's ignorance." — Confucius

Put a more modern way, Confucius is saying that we often don't know what we don't know. This is a truism that applies to many investors. Take risk, for example: a recent AMG Funds survey[1] found that:

80% of investors describe themselves as at least somewhat knowledgeable about investing...



91% of those same investors cannot identify basic risk measures

It's clear that investors have a blind spot when it comes to risk. However, despite being an intimidating concept, the basics of risk are largely straightforward to understand. Three concise questions summarize the essentials of what investors need to know:

1. What is risk?
2. What are the basic principles of risk?
3. How is risk measured?

What Exactly Is Risk?

The term "risk" can conjure some scary ideas. But for investors risk is simply the possibility of unexpected results. This means that in some cases:

- An investment may not perform as anticipated
- An investor may lose some or all of what they invest

Investors are often rewarded for these possibilities. In fact, being willing to take on these risks is why investments may provide a return (that is, a positive result) in the first place.

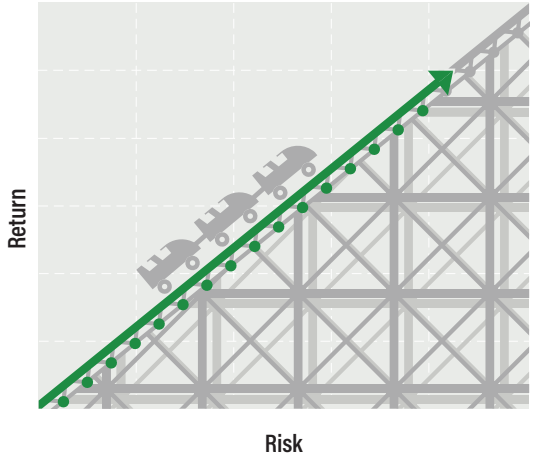
What Are the Basic Principles of Risk?

Despite being a complex concept, the initial realities of risk boil down to two straightforward statements:

- All investments have some level of risk
- In general, there is a direct relationship between risk and return

[1]AMG Funds' survey, Wealth Management Trends in America, was conducted online among investors with over $250,000 in household investable assets, who either make or share in making household savings and investment decisions. Data was collected between November 28 and December 7, 2016, among 1,000 respondents, age 18 or older, through an online consumer panel. Data from the survey was weighted by age and asset level to more closely reflect the overall population of households with $250k+ in investable assets as defined by the 2013 Survey of Consumer Finance. For more information please visit amgfunds.com.

Understanding Risk



Hypothetical example shown for illustrative purposes only,
and does not represent the performance of any specific investment products.

The latter statement is especially important. It means that the **higher** (or lower) the potential return of a given investment, the **greater** (or lesser) the risk. Keep in mind, however, that this is a guide, not an absolute. As noted earlier, the very definition of risk means that **any investment can yield unexpected results.**

After all, if more risky investments always yielded higher returns they would not be more risky.

How Is Risk Measured?

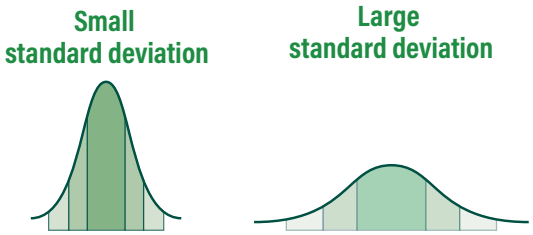
There is no singular way to assess or measure risk. However, two key measures are common.

The first is **beta**, which is a measure of the risk and provides an indication of how closely a given investment tracks the performance of the overall market. The market has a beta of 1, which means that in theoretical terms:

- An investment with a beta of **1.3** should outperform the market, as represented by a benchmark index, by 30% when the market goes up, and underperform by 30% when the market goes down. This means the investment is **more volatile** than the market.
- An investment with a beta of **0.7** should underperform the market by 30% when the market goes up, and outperform by 30% when the market goes down. This means the investment is **less volatile** than the market.

If beta reflects how an investment will perform relative to the market, the second measure, **standard deviation**, illustrates how much variation there is within the annual returns for a given investment. A higher standard deviation means more variability in annual returns and, therefore, more risk.

Ultimately, risk tolerance is different for every investor. However, having a good understanding of risk is a fundamental necessity for any investor and informs better decisions as they shape both their investment portfolios and their long-term financial futures.



About AMG Funds

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