

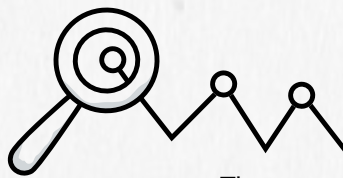
Activity 2

UNDERSTANDING RISK

PART 1: COMPARING OPTIONS

You are given \$1,000 to invest, and have a choice between two investments. The first is a low-risk option that earns a steady return of 6% per year. Your returns for the first 10 years will look like this:

LOW-RISK INVESTMENT ACCOUNT				
Year	Opening Balance	Interest Rate	Interest	Ending Balance
1	\$1,000.00	6%	\$60.00	\$1,060.00
2	\$1,060.00	6%	\$63.60	\$1,123.60
3	\$1,123.60	6%	\$67.42	\$1,191.02
4	\$1,191.02	6%	\$71.46	\$1,262.48
5	\$1,262.48	6%	\$75.75	\$1,338.23
6	\$1,338.23	6%	\$80.29	\$1,418.52
7	\$1,418.52	6%	\$85.11	\$1,503.63
8	\$1,503.63	6%	\$90.22	\$1,593.85
9	\$1,593.85	6%	\$95.63	\$1,689.48
10	\$1,689.48	6%	\$101.37	\$1,790.85



The second is a high-risk option that varies from year to year. If you could see into the future, you'd find that the annual growth/loss rate of return for this option would be as shown in the chart below. Use a calculator to fill in the blanks on the chart, then use it to answer the questions.

HIGH-RISK INVESTMENT ACCOUNT				
Year	Opening Balance	Growth/ Loss Rate	Growth/ Loss	Ending Balance
1	\$1,000.00	-12.00%	\$	\$
2	\$	-4.00%	\$	\$
3	\$	-9.00%	\$	\$
4	\$	29.00%	\$	\$
5	\$	24.00%	\$	\$
6	\$	26.00%	\$	\$
7	\$	10.00%	\$	\$
8	\$	6.00%	\$	\$
9	\$	12.00%	\$	\$
10	\$	14.00%	\$	\$

- Which account will have a higher balance after two years? _____
- Which account will have a higher balance after six years? _____
- Describe what you see in terms of comparing growth between the accounts.

- Which account will have a higher balance after 10 years? _____
- Which investment was a better choice? _____

PART 2: RISK TOLERANCE IN ACTION

- You have just won \$10,000 on a TV game show. Now you must choose between keeping the \$10,000 and quitting the game, or betting the entire \$10,000 in one of three alternative scenarios – if you win, your earnings increase; if you lose, you lose everything. Which do you choose?
 - _____ a. Keep the \$10,000 – it's better to leave with something than nothing!
 - _____ b. 50 percent chance of winning \$50,000
 - _____ c. 20 percent chance of winning \$75,000
 - _____ d. 5 percent chance of winning \$100,000
- Which of the following investments would you choose:
 - _____ a. Potential to earn \$600 or lose \$150
 - _____ b. Potential to earn \$2,000 or lose \$1,000
 - _____ c. Potential to earn \$5,000 or lose \$3,750

