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Ask any finance pro why most individual investors never get rich and the answers will vary. Some will say fear to act, some greed and some lack of patience. While all of these factors are certainly possible, thereâ€™s one that trumps them all: â€œtheir inability to assess risk.â€•

Question a few people about what they think of the stock market. Most likely, the answers will be something along the lines of â€œItâ€™s a good way to lose all your moneyâ€• or â€œItâ€™s nothing but a gameâ€• or â€œItâ€™s rigged against the little guy.â€•

These same folks think nothing of parking their money in a low-interest savings account year after year, blithely ignoring the fact that the purchasing power of their funds is being wiped out by inflation.

Too many investors get caught up in all the negative news pumped out by the media and ignore the longer-term performance of the stock market. Try telling Sally and Joe Middle America that a diversified stock portfolio is safer, over the long term, than bonds, bank accounts, or gold. Itâ€™s almost guaranteed they wonâ€™t believe you, especially if the market is gyrating as we have seen lately or in a slump like we saw in â€˜08.

Generally, our perception of risk works exactly backwards: when stocks, real estate, or any other asset class is getting cheaper, and therefore more value-positioned and possibly safer, we perceive it as riskier because it has lost some and may still be losing more of its value. When itâ€™s increasing in price, moving toward full market valuation and therefore more dangerous, many perceive it as safer.

The time when the â€œman on the streetâ€• tells you stocks are a great buy is when they definitely arenâ€ a shoe clerk starts giving you stock tips, itâ€™s time to take your money and run.

Here are five ways you can improve your ability to assess risk:

1) Block out the last few days or weeks. Look at whatâ€™s happening over a period of one to three years. Focusing only on whatâ€™s happening this week will lead you astray every time.

2) Evaluate all your alternatives. There is usually someone, somewhere whoâ€™s making money. If you donâ€™t like the odds in the United States, look at other countries, including emerging markets. Consider micro and small cap opportunities that donâ€™t necessarily move with the general direction of the market.

Look at various asset classes if you are so inclined including real estate, precious metals and other alternative investments such as commodities and long-short funds. But be forewarned: If everyone loves an asset class, it may not be your best choice.

3) Ask yourself whatâ€™s the worst that can happen. Get a handle on your economic fears by playing out various scenarios in your head. Is Johnson and Johnson going to stop selling cotton balls? Are people going to stop driving their cars and consuming petroleum products?

4) Keep in mind that â€œriskierâ€• assets can be the most popular ones. Safety stocks are great, but theyâ also in greater demand when things are bad which can drive their prices higher. The biggest bargains in a bad economy are usually in the small and micro cap areas. Buy a diversified portfolio of small caps, and youâ€™ll have less risk than you might think.

Of course, any one of them may go bankrupt, but theyâ€™re not all going to go bankrupt at the same time unless this really is the end of the world. If small caps and micro caps are too frightening for you, remember that a good market panic will drop the price of the stalwarts too. You may not make as much on the blue chips as you would in the best small caps, but it still wonâ€™t be very hard to beat the performance of the average bond or T-bill.

5) Look at facts, not opinions. Read several good books on stock market history, and compare the long-term returns of various assets. Look at seasonal anomalies like year-end tax selling and summer slumps. Pay attention to the returns of small versus large caps. Look for things that are almost always true, and use them to guide your investing.

Memorize principles like â€œSmall caps and mid caps tend to outperform large capsâ€• and â€œInvestors check their portfolios constantly do worse than those who check in once a month.â€• A solid set of principles will provide a much more reliable guide than listening to what the talking heads think this week. Remember, they have to fill the air waves with somethingâ€¦and itâ€™s not always something you need to hear.

Watching too much television or listening to too much water cooler chatter will lead you to invest in exactly the wrong things at the wrong time.

Examine fundamentals when youâ€™re tempted to panic. If your company has little or no debt and positive earnings, itâ€™s probably not going bankrupt any time soon. When the fundamentals tell a different story than the share price, wait a while. The two will come back into line; they always do.

Conclusion

The biggest threat to investorsâ€™ wallets is the misperception of risk. They buy things that are riskier than they think and bypass those that are actually safer. You can do better by looking at the actual facts behind the performance of your assets and turning off the noise.

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