Portfolio Size, Proximity to Retirement Impacts an Investor's Perception

What's Your Risk Tolerance?

by Alexandra Armstrong, CFP, CRPC, and Christopher Rivers, CFP, CRPC

The dictionary defines risk as "the possibility of suffering harm or loss; danger." Over the 10 years leading up to 2020, the moments of danger or loss in the markets were exceedingly brief. But as we saw this March, market conditions can change in an instant. Even experienced investors who had been through the crashes of 2008 and years prior were out of practice when it came to navigating a market meltdown.

If nothing else, the markets during the first half of 2020 reinforced the need to understand the "risk" portion of the risk/reward trade-off and come to terms with our own attitudes about risk.

Unlike measuring height or weight, there's no single unit of measurement for risk tolerance. There are a number of apps and programs that will measure your risk and return a proprietary "risk score" or "risk number." These measures are relative and useful only when measured on a constructed scale, in much the same way an IQ is measured.

Capacity Versus Tolerance

We think there are two basic ways of looking at risk: the amount of financial risk you can afford to take (your capacity for risk) and the emotional risk you're willing to take (your tolerance for risk). When figuring the capacity for risk, your entire financial situation should be considered. This includes your age, assets, cash flow, family situation, employment status and goals, among other factors.

Risk Capacity

If you're relatively young, are a two-income couple who doesn't spend all your income, and are saving for retirement, you can likely take more risk with your investments. You have more time to accumulate assets and it will be some time before you need them, so you have the capacity to experience market fluctuations along the way.

Conversely, if you're retired, and depend on cash flow from your assets to cover some or all of your living expenses, you can't afford to take as much risk. With retirees living longer than they did in previous generations, this has become especially important, particularly if you don't have pension income, which few people have nowadays.

The size of your total assets relative to your needs influences your attitude toward risk as well. If you have more assets than needed to maintain your lifestyle, you have the capacity to take more risk with at least some of your investments. However, it's not just the size of your savings. For instance, a retiree with a pension that covers most daily living expenses, and $800,000 in a portfolio, has a relatively high capacity for risk, as market fluctuations would not directly affect his daily standard of living.

By contrast, a wealthier person, with $1.5 million in retirement savings, but who has no pension, may well have a lower capacity for risk, even though she has more assets. If she depends entirely on her investments to fund her retirement, market declines can have a clear impact on her budget and standard of living.

Risk capacity can be measured, or at least discussed, using hard numbers. After assessing your current cash flow needs and future goals, and comparing them to your assets, you can approximate a range of how much your portfolio can fluctuate and still safely provide the necessary cash flow. While there is still some gray area and some "art" involved in this assessment, it is rooted in the financial planning numbers. This is where working with a financial planner can especially help you hone in on your capacity for risk.

Risk Tolerance

Capacity for risk is only one piece of the puzzle. In addition, it is crucial to measure your emotional attitude toward risk taking. If your parents lived through the high inflation of the 1970s, or if they made mistakes managing their own money, you may have learned to cast a wary eye on taking risks with your own money. Even if the original experience wasn't your own, traumatic family experiences and cautionary tales can have a lasting effect on your own attitudes.

In addition, your attitude toward taking risk can vary over time based on your most recent experiences — either positive or negative — when you took risks. Younger investors, who began investing after 2009, experienced a 10-year period of substantial reward and minimal risk. So it would be no surprise if they tend to be more aggressive with their investments. This is what behavioral psychologists call recency bias, giving greater importance to recent experience than is warranted.

Conversely, an investor who started 10 years earlier, in 1999, would have experienced two spectacular market meltdowns in 2001 and 2008, and would likely have very different feelings about investment risk.

Unlike capacity, assessing risk tolerance is not a math problem. The likelihood for a market meltdown in 2020 was the same whether you turned 25 this year or 45.

But the perception of the chance of a meltdown likely differed greatly depending on your prior experience. This is where risk tolerance questionnaires and tools come in. They're designed to tease out your experiences with money and risk, and your emotional willingness to take on the risk and tolerate volatility.

Calibrating Your Investments for Your Risk Tolerance

Once you've assessed how much risk you can afford to take (capacity) and how much you're comfortable taking (tolerance), you can focus on risk-reduction techniques. It's important to start with the basic premise that it's virtually impossible to avoid risk altogether. All investing is on some level a simple trade-off between risk and reward.

When investing, the first way you can control the negative impact of risk taking to some extent is by doing your homework. There's a difference between taking educated risks and speculating. Speculating is equivalent to betting at the racetrack by putting all your money on one horse with the name you like or the color of silks you prefer.

As a BetterInvesting member, you're familiar with this concept of educating yourself. A company might have a wonderful product, but you need to check out its competition, the amount of debt the company has, its profits and the relationship of earnings to the current market price before deciding to invest in that company's stock.

Diversification

Diversifying your investments is the most powerful way to manage risk in your portfolio. We've always had problems with artificial formulas that tie your asset allocation to your age. One popular formula is subtracting your age from 100 to determine the percentage you should hold in stocks. According to that formula, if you're 65 years old you should have 35% in stocks and 65% in bonds. These rules of thumb can be a good way to

> **"You don't have to be a speculator to build wealth successfully over the long term."**

frame the conversation, but rules of thumb are constructed to be general guides for the public at large, and they've been formulated without an any regard to your own personal situation.

Furthermore, it is important to know what kind of stocks you own and what kind of bonds you own. Investing in a blue-chip stock with an established market share and dividend/earnings record is quite different from investing in a startup company that pays no income, though both fall into the "stocks" bucket in the asset allocation example above. Similarly, investing in a corporate bond with a good credit rating involves less risk than investing in a high-yield bond for which the credit rating's much lower.

Work With a Professional

Another way you can limit your risk is to work with an experienced financial adviser. Although this isn't necessarily a panacea, this professional can show you different investment alternatives and explain both the risk and return potential of each choice. That way you can put together a portfolio that matches your own risk tolerance.

We explain to clients that there's no right or wrong attitude toward risk. What's important is that you're honest with yourself and your adviser as to what your risk tolerance is and that you construct your investment portfolio accordingly. Your adviser can help hone in the proper amount of risk by using risk assessment tools and discussing all of the factors we've written about above.

If you're married, you need to consider whether you have different levels of risk tolerance than your spouse. This can lead to family conflict. It's critical that you discuss this issue with each other and understand each other's tolerance for risk.

The first half of 2020 has been difficult for all of us. With respect to the markets, even though it appears we have recaptured much of the market losses experienced earlier this year, the decline reminded us that nothing goes up for ever, that it's important to have a rainy day fund and that you need to understand what you own.

Although taking some risk is essential to earn returns, it's been our experience that you don't have to be a speculator to build wealth successfully over the long term. We urge you to try to ignore the daily fluctuations of the market and adopt a slow, steady and consistent approach to investing, calibrated to your tolerance and capacity for risk. Keep in mind the fable of the tortoise and hare!

Alexandra Armstrong is a CERTIFIED FINANCIAL PLANNER professional and Chartered Retirement Planning Counselor and founder and Chairman Emeritus of Armstrong, Fleming & Moore, Inc.

Christopher Rivers, a CERTIFIED FINANCIAL PLANNER professional and Chartered Retirement Planning Counselor and co-author of this article, is a principal of Armstrong, Fleming & Moore, Inc., Located at 1800 M St. NW, Suite 1010-S, Washington, D.C. 20036-5813, 202/887-8135.

This material has been provided for general informational purposes only and doesn't constitute either tax or legal advice. Investors should consult a tax or legal professional regarding their individual situation. Securities offered through Commonwealth Financial Network, member FINRA/SIPC. Advisory services offered through Armstrong, Fleming & Moore Inc., a Registered Investment Adviser, are separate and unrelated to Commonwealth Financial Network.