Know Your Risk Capacity and Tolerance

by Alexandra Armstrong, CFP®, CRPC® & Christopher Rivers, CFP®, CRPC®

The dictionary defines risk as "the possibility of suffering harm or loss; danger." We believe that the foundation of any good investment strategy should start with an analysis of risk versus reward. Historically, markets have provided rewards to long-term investors, with periodic risks in the form of declines that may be sharp but short term. The challenge is that there is often little warning that risks are on the horizon and no one rings a bell to sound the "all clear" when the risk has passed.

After a relatively quiet decade in the markets, the pandemic showed us how quickly things can change. A rapid market drop in March 2020 was followed by an almost equally rapid recovery. Even experienced investors who had been through the crashes of 2008 and 1987 hadn't seen something like this before. In 2022, we saw a more "normal" downturn that was more prolonged and painful, followed by a strong recovery last year. These gyrations have reinforced the need for investors to understand the "risk" portion of the risk/reward trade-off and to come to terms with their 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 software packages that will assess your risk and give you a proprietary "risk score" or "risk number." These measures are relevant and useful only when measured on a constructed scale, in much the same way an IQ is measured.

Even the meaning of "risk" can depend on the situation. When individuals talk about the risk they experience in their own financial affairs, they're talking about something different than investment researchers discussing the volatility of a particular investment. When assessing an individual investment, volatility is a measure of price swings both up and down. But at the investor level the primary worry tends to be about a decline. Psychological research has shown that investors feel more pain from losing a dollar than they do pleasure from gaining a dollar.

As part of our financial-planning process, we ask our clients to complete a risk-tolerance questionnaire, but this only gives us a "best guess" of the risk they're willing to accept. There is research indicating that when it comes to investing each of us has a baseline level of risk tolerance, similar to the baseline level of happiness that we tend to return to over time. However, we recognize that there can be fluctuations based on life stage or recent events.

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 and employment status, among other factors. These are the basics of a sound financial plan.

RISK CAPACITY

For example, a young, two-income couple who doesn't spend all their take-home pay has the capacity to take more risk with their investments because they have more time to accumulate assets. Even if over the near term the investments decline, over the long-term markets tend to move upward and they have time to make additional investments in the future.

Conversely, a retired couple who depends on cash flow from their assets to cover some of their living expenses has less risk capacity. Fluctuations in the market can directly affect their cash flow and style of living. With retirees living longer than they did in previous generations, this has become especially important, particularly if they don't have meaningful pension income.

The size of total assets relative to needs influences your attitude toward risk as well. If a couple has more assets than needed to maintain their lifestyle, usually they're willing to take more risk with at least some of their investments.

To be clear, it's not just the size of the portfolio. A retiree with a pension that covers most daily living expenses, and $800,000 in a portfolio, has a relatively high capacity for risk, since market fluctuations wouldn't directly affect their daily standard of living. By contrast, a wealthier person, with $3 million in retirement savings but no pension may have a lower capacity for risk, even with more assets.

Risk capacity can be measured, or at least discussed, using hard numbers. After assessing your cash flow needs and comparing them to your assets, you should have an idea of how much your portfolio can fluctuate and still safely provide the necessary income. While there are still some gray areas and some "art" involved in this assessment, risk capacity is rooted in the financial planning numbers.

RISK TOLERANCE

Capacity for risk is only one piece of the puzzle. It's equally important to measure emotional attitudes toward risk taking. If your grandparents lost money in a market crash or your parents mismanaged their finances when you were growing up, you may be reluctant to take much risk 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 recent experiences — either positive or negative — when you took risks. If a recent speculative investment worked out well, you'll probably be more willing to take risks in the future. This is what behavioral psychologists call "recency bias" — giving greater importance to the most recent event. Unlike risk capacity, there are no objective numbers involved in assessing risk tolerance. This is where risk tolerance questionnaires and tools can be helpful. They're designed to flesh out your experiences with money and risk, and your emotional willingness to take on the risk and tolerate the trade-offs.

CALIBRATING FOR YOUR OWN PERSONAL RISK CAPACITY AND TOLERANCE

Once you've assessed how much risk you can afford to take (capacity) and how much you're comfortable taking (tolerance), you should focus on risk-reduction techniques. It's important to start with the basic premise that it's virtually impossible to avoid risk altogether.

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 and 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. We think this is much too conservative a rule. What is important is what other sources of income you might have. These rules of thumb can be a good way to frame the conversation, but rules of thumb are constructed to be general guides for the public at large and they've been formulated without any regard to your own personal situation.

Furthermore, it's important to know what kind of stocks and 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. 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

Of course, we are quick to say, another way you can limit your risk is to work with an experienced financial adviser. Although this isn't necessarily a panacea, a professional can show you different investment alternatives and explain both the risk and return potential of each choice. Together you can look at your situation more objectively than you might alone. That way, you can put together a portfolio that matches your 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 focus on 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, consider whether you have different levels of risk tolerance than your spouse. This can lead to family conflict. You need to discuss this issue with each other and may have to make some compromises. For instance, a spouse who's more willing to take risk might invest part of the portfolio in more aggressive investments than the partner.

The 2020s have been a roller coaster decade in markets thus far. We've seen first-hand that timing the market can be a futile exercise. 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.