Understanding Your Risk Tolerance

Do you recognize the major factors that may affect it?

How's your ability to withstand short-term losses? This is the question at the core of any discussion of risk tolerance. Some people are able to ride through turbulence in the financial markets with a shrug while others suffer headaches. Many investment professionals recommend that their clients adopt an investment policy statement (IPS) to do so, and to address matters such as long-range goals and desired returns.

What life factors can shape your risk tolerance? Two come quickly to mind. The first factor is your age. The second is your time horizon.

As you age, you have fewer years to recoup market losses. So gradually reducing the amount of risk in your portfolio over time has merit. Many financial professionals advocate this, and Wall Street firms have even created investments around this premise, commonly featured in employer-sponsored retirement plans.

Your timeline to retirement can also influence your risk tolerance. If you are sure that you will start tapping into your retirement savings in 2021, your appetite for risk may pale compared to someone whose retirement may start at some vague point in the 2030s. Broadly speaking, your time horizon for any financial goal affects your risk tolerance in investing toward it.

What market factors can shape your risk tolerance? Four stand out. The most obvious one is *market risk.* One common measure of market risk is standard deviation, which tracks the variance of an investment's return from its mean return during a stated period. Adding and subtracting the standard deviation to a mean return shows the range of returns that may be anticipated 67% of the time. If an investment has a high standard deviation, it means that its returns have varied from the mean to a greater extent than one with a low standard deviation. (You could argue that history means nothing with regard to an investment's future performance, and that argument is legitimate – but lacking clairvoyance, we study history.) Across 1926-2012, the S&P 500 had a standard deviation of 19.1%.[1]

Beta weighs volatility versus the S&P 500, NASDAQ or other broad benchmark. The benchmark is given a value of 1, and an investment with a beta above 1 would show greater volatility than the benchmark. A 1.1 beta indicates an investment that in theory should move 10% more than the benchmark does. The problem with beta is that some investments have low correlation to the benchmark used.[1]

The impact of market risk can be magnified when a portfolio lacks diversification. Having more eggs in more baskets promotes more insulation against market shocks.

Liquidity risk can emerge significantly, especially as you age. Sometimes retirees will invest in certain financial vehicles and realize later (with frustration) that those dollars are “locked up;” they can’t get at that money, the investment is illiquid. If they want their money back, they’ll have to pay a penalty. Taking that kind of risk may be more than they can handle.

Marketability risk is the cousin of liquidity risk. It isn’t a measure of liquidity, but of tradability. If you can sell an investment quickly, its marketability risk is lower. If you can’t, its marketability risk is higher. Some people can’t tolerate investments that they can’t get in and out of.

Finally, you have *inflation risk.* This is the risk of your purchasing power lessening over time. When you invest in such a way that you can’t keep up with inflation, you lose ground economically. Suppose yearly inflation increases to 3% soon. That means that a year from now, you will need $103 to buy what you bought for $100 a year earlier. In ten years, you will actually need $134.39 rather than $130 to buy what you bought a decade back because of compound inflation. Its effect is just like compound interest.[2]

Look at retirees with conservative portfolios featuring a plethora of fixed-income investments. In a world where stocks are returning 10% a year or better, their returns have been a fraction of that. In addition to the opportunity cost they are currently paying, they risk struggling economically if the pace of inflation quickly accelerates.

What kinds of risks do you feel comfortable assuming? This is the big-picture question, the question for today and tomorrow. A discussion with a financial professional may help you confidently determine your answer.

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Citations.

1 - us.axa.com/investments/evaluating-investment-risk.html [6/13]
2 - inflationdata.com/articles/2013/02/05/impact-inflation-savings/ [2/5/13]