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Building Wealth Wisely

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The Right Amount of Risk

Many market shocks are relatively short-lived once investors conclude the event is unlikely to cause lasting economic damage. Still, major market downturns such as the 2000 dot-com bust and the 2008-09 credit crisis are powerful reminders that we cannot control or predict exactly how or when precarious situations will arise.

Your portfolio's risk profile should reflect your needs and objectives, as well as your ability to endure periods of market volatility - both financially and emotionally. Here are some questions that may help you evaluate your personal relationship with risk.

What Is Risk?

The most common definitions of investment risk are rooted in uncertainty. Most people think of market risk as the possibility that their investments will lose value because of a broad decline in the financial markets, which can be the result of economic or sociopolitical factors.

There are a variety of ways to measure the likelihood that the return on an investment will diverge from the expected return. One accepted method is the standard deviation of returns. This figure helps investors understand how widely returns may fluctuate around their average. However, standard deviation is not an ideal risk measurement because it treats downside risk (the bad kind) and upside risk (the good kind) as equals.

A better way to measure risk is to quantify the distribution of negative returns. Maximum drawdown data captures the peak-to-trough declines of an investment over historical periods. While not a worst-case scenario, it can provide a sense of how much pain might be in store in a down market.

What Is the Real Risk?

Real risk lies in how we respond to the ups and downs in the market. In general, we are risk-averse beings by nature. The concept of risk is deeply personal and difficult to convey with numbers. How investors experience and respond to risk will vary depending on personality, circumstances, and experience. An investor's risk appetite may fluctuate with the market, and it might also change with time.

An investor's risk tolerance is driven in part by personality. Some people seem to be born risk-takers, whereas others are cautious by nature, but an investor's true psychological risk

tolerance can be difficult to assess. Some people who describe their personality a certain way on a questionnaire may act differently when they are tested by real events.

How much risk can you afford?

An appropriate level of risk generally depends on your current financial position (income, assets, and expenses), as well as your age, health, future earning potential, and time horizon.

Your time horizon is the length of time before you expect to tap your investment assets for specific financial goals. The more time you have to keep the money invested, the more likely it is that you can ride out the volatility associated with growth-oriented investments. A more aggressive risk profile may be appropriate if you're investing for a retirement that is many years away. However, investing for a teenager's upcoming college education calls for a more conservative approach.

Investors who are willing to accept more investment risk usually benefit from higher returns in the good times, but they also get hit harder during the bad times. A more conservative portfolio generally means there will be milder lows but also lower returns.

How much risk may be needed to meet your goals?

If you know how much money you have to invest and can estimate how much you will need in the future, then it's possible to calculate a "required return" (and a corresponding level of risk) for your investments. Older retirees who have sufficient income and assets to cover expenses for the rest of their lives may not need to expose their nest eggs to too much risk. Investors who have accumulated substantial financial assets likely have a greater ability to take risk, but they may be less inclined to assume risk and instead choose to preserve their capital.

On the other hand, some risk-averse individuals may need to invest more aggressively to accumulate enough money for retirement and offset another important risk: that inflation could erode the purchasing power of their assets over the long term. Most people underestimate the impact that inflation will have on their retirement plans. At a 3% inflation rate, a $100,000 nest egg declines in purchasing power to $40,000 over a 30-year period.

Just because an investor doesn't like the ups and downs of the stock market doesn't mean that he or she can afford to skip the ride.

How much risk are you comfortable taking?

In general, investors with a higher acceptance of volatility favor stocks, and those who are more squeamish lean toward bonds and cash. Striking an appropriate balance between the two is easier said than done.

An investor's attitude toward risk can change over time. New investors may be more fearful of potential losses, and serial entrepreneurs may be more comfortable with risk than company men and women. People who have lost vast sums in the market in the past may be uneasy about taking risk in the future, but investors who have experienced the long-term cyclical nature of the economy and financial markets may be more comfortable with short-term market swings.

Attitudes about risk can also shift with the markets. Several years into a bull market, during a period of relative calm, investors tend to have a higher willingness to take risk. Conversely, in March 2009, most investors were highly risk adverse (even though it was actually a tremendous buying opportunity).

How can we manage risk?

Market declines are an inevitable part of investing, but abandoning a sound investment strategy in the heat of the moment could be detrimental to your portfolio's long-term performance. In many ways, the best portfolio is the one you're most likely to stick with the next time markets turn nerve-racking.

The most effective way of managing risk is to select an appropriate mix of assets. As a starting point, most retirement planning experts recommend that the percentage of equities in your portfolio should equal 120 minus your age (for example, 120 - age 60 = 60% in equities). You can then adjust your allocation based on your needs, circumstances, and risk tolerance.

One thing you can do to prepare for the inevitable ups and downs is to anticipate scenarios in which the value of your investments falls by 20% to 40%. If you are overly anxious about the possibility of such a decline, it might be helpful to reduce the level of risk in your portfolio now. Having the right plan in place could help you manage your emotions when turbulent times arrive.