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WEEKEND INVESTOR

Check Your Tolerance for Investment Risk Now, Before Markets Sag

Five Years Into a Bull Market for Stocks, Risk Calculators Can Help Evaluate Your Asset Mix

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Don't wait for the next crisis to hit. *iStock*

The stock market has been on an impressive run the past five years, yet many investors worry that disappointing corporate earnings, jitters over European banks or some other bit of bad news could soon end the party.

Don't wait for the next crisis to hit. Now is the time to get a handle on your tolerance for risk and be sure that your retirement accounts are invested in a way you will be able to live with in good times and bad.

That can be tricky, not least because there is disagreement among experts about whether an investor's risk tolerance changes with the markets or remains steady even as prices swing.

In the first camp are researchers such as Michael Finke, a finance professor at Texas Tech University and co-author of a study published in the June issue of the Journal of Financial Planning titled "Do Large Swings In Equity Values Change Risk Tolerance?"

"We're more risk-tolerant after the market has gone up and more risk-averse when it's going down," he says. As evidence, Mr. Finke notes that more money typically flows into stock funds during market upswings, while investors pull out more when the market melts down.

Geoff Davey, co-founder and director of FinaMetrica, an Australian firm that creates a risk-tolerance questionnaire that is used by financial planners in the U.S. and abroad, takes the opposing view that our sensitivity to financial risk, much like a deep-grained personality trait, is generally stable.

He points to the fact that his risk-profile test generates consistent scores whether it is administered in up or down markets. As for people investing more aggressively during bull markets and more conservatively in bears, Mr. Davey says that is because their perception of risk—not their appetite for it—has changed.

Robert Babboni

"They're underestimating the risk they're taking after stock prices have risen and overestimating it after prices have dropped," he says.

Both perspectives can be useful in shaping an appropriate retirement investing strategy. On the one hand, recognize that you may be tempted to invest more aggressively when the market is rising and more cautiously when it is falling.

But also be sure that investing decisions made in the heat of the moment don't leave you with a portfolio that is out of sync with your inherent appetite for risk.

One place to get a handle on the level of risk that is right for you is by completing a questionnaire such as the one offered by Mr. Davey's firm. FinaMetrica offers a 25-question risk-profile questionnaire for $45 at www.myrisktolerance.com that scores you on a scale of 0 to 100 and comes with a 10-page report for interpreting the results.

Under the Resources and FAQs tab at the company's website for advisers, www.riskprofiling.com, you can download an asset-allocation guide that translates your score into an appropriate percentage of "risky assets," such as stocks.

For those unwilling to pay or endure such in-depth questions, Vanguard Group, the large asset manager, has a shorter Investor Questionnaire that is available free online. After answering 11 questions focusing on such issues as what size loss you feel you could comfortably stand and how long you intend to invest your money, you will come away with a suggested mix of stocks and bonds.

The two questionnaires are different, but investors can end up with suggested portfolio allocations that are in the same ballpark.

The next step is to see how that recommended portfolio might fare under stress, and determine whether you would be comfortable with the results. You can't predict future performance, of course, but you can estimate how a given mix of assets would have performed during severe downturns in the past.

Assume, for example, that your risk-tolerance assessment recommended a portfolio of 70% stocks and 30% bonds. From the stock market's peak in 2007 to its trough in 2009, stocks lost roughly 55% and bonds gained about 7%, which means holding a 70-30 mix over that period would have left you down more than 36%.

If that kind of setback might have led you to make rash moves—such as selling all your stocks at the low and putting the proceeds in a mattress, thereby missing the subsequent bull market—then you may need to dial back to a less aggressive allocation, say, 50-50, which would have lost less than 25%.

Remember, though, that while ratcheting down your stock exposure should give you more shelter during market squalls, the lower returns that come with a more conservative mix could make it harder for you to build a nest egg large enough to support you in retirement (or, if you already are retired, draw sufficient income from your savings).

That means you may need to give up some short-term protection and comfort in return for potentially higher long-term returns, while at the same time not stretching so far out of your comfort zone that you risk selling in a panic at market lows.

You can get an idea of how various stock-bond mixes could translate into different levels of retirement income by using a retirement calculator, such as the one provided by T. Rowe Price Group, another large mutual-fund firm.

Make a conscious effort to guard against a common tendency to get lulled into a false sense of security during booming markets and, conversely, to become overly cautious and pessimistic after prices have collapsed.

The goal is to create a portfolio that jibes with your underlying tolerance for risk, and then largely stick with it despite the ups and downs of the market.

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