

Rethinking Your Risk Attitude

Investing is all about your risk attitude, risk capacity, risk tolerance and, most importantly, drawdowns (losses).

Risk Attitude

Your risk attitude is comprised of two elements, which though often used interchangeably, are quite different: risk capacity and risk tolerance.

What's your risk attitude?



Risk Capacity

Your risk capacity is a measure of your "financial ability" to sustain risk.

For an exaggerated example of risk capacity, in his annual letter to Berkshire shareholders, dated February 28, 2014, Warren Buffett revealed the part of his estate plan that would take care of his wife, Astrid, if she outlived him. Buffett's will left some cash to a trustee for his widow's benefit along with this advice: "Put 10% of the cash in short-term government bonds and 90% in a very low-cost S&P 500 index fund. (I suggest Vanguard's.) I believe the trust's long-term results from this policy will be superior to those attained by most investors...."

During the last two secular bear markets in 2000-2002 and 2007-2009, such a 90/10 split would have exposed Mrs. Buffett to losses in the 40% range. However, Mrs. Buffett has the "risk capacity" to lose a ton of money - and she can wait several years for the market to recover from her losses without putting a dent in her retirement income or lifestyle - a luxury most investors can't afford.

For a more realistic example, if you need to fund retirement withdrawals immediately, at say \$60,000 a year, from a \$1,000,000 investment portfolio, then you have very little capacity to take excessive risks - any failure could be disastrous.

Risk Tolerance

Your risk tolerance measures your "emotional ability" to handle risk.

While risk capacity is about your financial ability to underperform and/or lose money in pursuit of higher returns, risk tolerance measures your willingness to enter into such a potential risk/reward trade-off in the first place.

In other words, your risk tolerance may be such that certain riskier investment portfolios - which may provide the best probability of achieving higher long-term returns from a financial perspective - simply may not be suitable for you from an emotional perspective - because you cannot tolerate volatility.

Returning to the Mrs. Buffett example above - despite having ample risk capacity - if Mrs. Buffett has a low tolerance for risk, and she cannot emotionally stomach any degree of market declines, then Mrs. Buffett can look forward to many sleepless nights ahead of her thanks to the volatile investment portfolio that her husband plans to leave for her.

Drawdowns (Losses)

Evaluating your attitude toward drawdowns is perhaps the single best way to identify your risk tolerance and assess if you will or won't be able to stick with a plan.

"Investing is all about Drawdowns."

- Leeland Gray

A Drawdown Analysis highlights the maximum declines inherent in an investment portfolio - in other words, the maximum historical loss from a market top to a market bottom (not just in a single year). A drawdown analysis also helps you to understand not just the magnitude of historical losses, but the duration of historical losses - which may have spanned several months or years - before the investment portfolio recovered from its losses.

It's important to measure drawdowns in dollar terms, not just in percentages, in order to determine the actual loss in dollar value that occurred from a market top to a market bottom. This represents the most strenuous test of risk tolerance that you can experience. It conveys more clearly what kind of risk you are taking on - and often determines whether you decide to change an investment portfolio - or investment advisor.

For example, let's assume hypothetically that you are being given a sales pitch to invest in the S&P 500 Price Index. It's one thing to be told that you should invest in the S&P 500 Price Index because it had an annual compound growth rate of 10.90% during the five years ending 03/31/2017. However, the sales pitch takes on a completely different perspective if you are told that you must be both willing, and able, to risk losing over 50% of your money in pursuit of those potential lofty returns, based upon historical drawdowns (losses). For example, if you hypothetically invested \$1,000,000 in the S&P 500 Price Index (you cannot invest directly in an index) entering into the bear market that began in November 2007, you would have lost 52.56% or \$525,600, and you would not have recovered from your losses until five years and three months (63 months) later in January 2013 (and that's without factoring in inflation).

Sequence-Of>Returns Risk

While all equity investors face market risk, which concerns how market volatility causes investment returns to vary over time in comparison to long-term average market returns, retiree equity investors are confronted with an additional phenomenon known as sequence-of-returns risk - retiring before a bear market begins or during the early stages of a bear market.

The specific sequence of market returns matters significantly during the withdrawal phase of retirement, when the impact of drawdowns (losses) is especially magnified. Losses, coupled with withdrawals, can deplete wealth rapidly, sending portfolio values spiraling downward, with relatively little left to benefit from a subsequent market recovery.

Millions of retirees' investment portfolios were devastated by sequence-of-returns risk when they retired before or during the early stages of the 2000-2002 and 2007-2009 bear markets, causing their retirement income and lifestyle plans to implode.

Summary

If you can't tolerate the drawdowns of an investment portfolio that best accomplishes your financial objectives, then you won't stick with the investment plan - so it really doesn't matter what the "best" portfolio is from a return perspective - and it's time to change your financial objectives. However, once you determine that you are comfortable with an investment portfolio - even in its darkest moments - then there's a much greater likelihood that you will stick with your plan and harvest long-term wealth through bull and bear markets.

Green Pastures uses a combination of your financial risk capacity, your emotional risk tolerance, and your attitude toward drawdowns to determine the most suitable investment portfolio for you. The end result are managed portfolios that seek to eliminate emotion, reduce volatility, and help you achieve your financial objectives at a risk level you are comfortable with - peace of mind investing.

© 2017 - 2018 Green Pastures Wealth Management LLC. All Rights Reserved.