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How to Measure Your Risk Tolerance

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Wealth Management is more than just investments. It encompasses a disciplined professional approach, using a broad range of services and an experienced team of advisers.

I can help you put together your specialized team of investment, tax, legal and insurance advisers and then lead the development and implementation of your integrated wealth management plan.

If you are within 10 years of retirement, let me help you understand how the retirement landscape has changed and how these changes can impact your current and future financial decisions.

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How to Measure Your Risk Tolerance

What is risk tolerance?

In general

How do you feel about taking risks? Take this short quiz:

1. Do you put on the car brake when the traffic light turns yellow, or do you step on the gas? If you put on the brake, give yourself one point. If you step on the gas, give yourself three points.

2. Do you fill the gas tank when the needle reaches halfway, or do you run a few miles on empty? If you fill the tank halfway, give yourself one point. If you run on empty, give yourself three points.

3. Do you take the long way because it's the way you know, or will you take a shortcut you've never taken before? If you take the long way, give yourself one point. If you'll take the shortcut, give yourself three points.

4. Do you take the train long distances, or do you prefer to fly? If you take the train, give yourself one point. If you fly, give yourself three points.

Now, add up your points. The maximum score is 12 points, and the minimum is 4. Most people will fall somewhere in between. Your score reflects your attitude toward risk and indicates your ability to accept or tolerate risk. Those of you with a higher score can accept a relatively great amount of risk and are referred to as risk tolerant. On the other end of the spectrum, those of you who scored low can accept very little risk and are referred to as risk averse. Those of you who scored in the middle are risk neutral or risk indifferent.

Note: This quiz is not scientifically based--it's being used only to illustrate a point. Quantifying risk tolerance is not an exact science. See below for more on this.

Risk tolerance in the investment world

In the investment world, there are two aspects of risk tolerance: (1) an investor's capacity for risk, or ability to absorb losses, and (2) how comfortable an investor is with risk.

An investor's capacity for risk is looked at purely from a financial point of view. In other words, the simple question is asked: How much money can the investor afford to lose? An investor should never invest more than he or she can afford to lose.

How comfortable an investor is with risk, from an emotional standpoint, depends on many factors, including his or her objectives and goals, life stage, personality, knowledge of investing, and investment experience. All investors are able to emotionally accept a certain amount of investment risk; some more, some less. Some investors will hang on to an investment during downturns in the market, while others will bail out at the first sign of trouble. An investor should never invest more than he or she is comfortable with. If an investor is losing sleep thinking about his or her investments, he or she has invested too much.

Investors typically fall into three categories of risk tolerance: aggressive (those who are risk tolerant), conservative (those who are risk averse), or moderate (those who are risk neutral or risk indifferent).

How risk tolerant you are is important, because it is one of the basic factors in determining the best investment strategy for you. Your risk tolerance can affect both the types of investments you make and the way you choose to diversify your portfolio.

Investment risk defined

Before we go any further, let's define investment risk. Investment risk refers to the way the price of an investment fluctuates or changes in value from time to time. These fluctuations are referred to as price volatility. The more the fluctuation--in frequency and in amount--the higher the volatility. Generally, the higher the volatility, the greater the risk.

There are three things about risk of which you need to be aware: (1) the risk-return tradeoff, (2) the investment planning time horizon, and (3) the different types of risks that exist. You should have a solid understanding of each of these issues in order to select investments that maximize potential returns within your acceptable risk levels. Here is a brief discussion of each.

As risk increases, the potential for return increases. This is known as the risk-return tradeoff. We know this because, historically, investments with greater risk have provided higher returns. The more aggressive you are as an investor, the more risk you take, and the more likely you are to earn a high return (but only if a return is earned at all). Conversely, the more conservative you are as an investor, the less risk you take, and the less likely you are to earn a high return (but the less likely you are to lose your investment).

For more information about the risk-return tradeoff, see Understanding Risk.

The length of time you plan to stay invested in a particular vehicle is referred to as your investment planning time horizon. Generally speaking, the longer your time horizon, the more you can afford to invest more aggressively, in higher-risk investments. This is because the longer you can remain invested, the more time you'll have to ride out fluctuations in the hope of getting a greater reward in the future. Of course, there is no assurance that any investment will not lose money.

For more information on the investment planning time horizon, see Understanding Risk.

Finally, many types of risks can affect an investment. Each investment is subject to all of the general risks associated with that type of investment. Risk also arises from factors and circumstances specific to a particular company, industry, or class of investments.

For more information on this topic, see Types of Risk.

Fear vs. confidence

When we speak about risk tolerance, we are concerned about the investor as a person. Perhaps risk tolerance can more easily be understood as fear vs. confidence. When people invest, they're taking a chance to earn more. Just the thought of losing money can provoke anxiety in most of us.

Fear can be a good thing because it makes us careful, so that we try to make investment decisions wisely, in a way that won't put our financial well being in jeopardy. But fear is a two-edged sword. Too much can cause you to lose out.

> **Example(s):** A fearful investor buys Treasury bonds for 20 years at an interest rate of 5 percent. However, inflation during those 20 years rises at a rate of 6 percent. The fearful investor has actually lost purchasing power because inflation has eaten it up.

The flip side of fear is confidence, which comes with experience. The more familiar an investor becomes with investing, the more aggressive he or she is likely to become. As confidence grows, generally, so does success.

The role of change

An investor's risk tolerance may not be static (although authorities argue about this). Personal and outside factors may influence your risk tolerance at any given time or over a period of time. Thus, you might expect changes in your feelings about risk when there are increases or decreases in your family obligations, major shifts in the economy, or other such circumstances. It is wise to be prepared to modify your investment plan should such changes occur.

How is risk tolerance measured?

Not an exact science

There are tests that measure risk tolerance to assess how an investor reacts to different types of risk. These tests aren't foolproof, of course, since we are talking about psychological behaviors that can vary under different conditions. However, these tests are designed to give you a general sense of how much investment risk you can accept, and the results are generally considered reliable. Generally, risk tolerance tests fall into two categories: investment preference tests and psychological tests.

Investment preference tests

Typically, an investment preference test is a questionnaire that addresses preferences for selected investment vehicles. It asks questions about your current financial situation, goals, and past investment experience. This type of test is easy to construct and relatively simple. The disadvantage, though, is that it does not accurately gauge risk-taking propensity because it does not deal with emotional reactions to risk.

Psychological tests

A psychological test is a more elaborate questionnaire that attempts to gauge an investor's attitude toward risk. This type of test generally includes questions about your feelings or behavior, or it may ask you to respond to hypothetical situations. This method of testing is easy to administer and can actually be fun to take. The disadvantage is that people generally like to consider themselves as risk-takers and may not respond as accurately as they should.

Some interesting results

Authorities in this area have compiled the results of risk tolerance tests collected from various kinds of situations and through a wide range of measurement techniques. Here are some of their findings:

- Risk taking is an admired quality in our society
- In general, people tend to be risk averse
- The firstborn is more risk averse than younger siblings
- Risk aversion decreases with wealth and income
- Some people take risks just for the thrill
- Single people take more risks than married people
- Men take more risks than women
- Younger people take more risks than older people
- People who work on commission take more risks than those on straight salary
- Those who are successful on the job take more risks
- Business executives take more risks with business investments than with their personal investments

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The effectiveness of any of the strategies described will depend on your individual situation and on a number of other factors. After reviewing your personal situation, we may recommend that you not use any strategy in this document but instead consider various other strategies available through our practice.

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