My Guide to Risk Tolerance

What You Need to Know to Invest With Confidence

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“Risk comes from not knowing what you’re doing.”

---Warren Buffet

Look up risk in the dictionary and you see it defined as "exposing oneself to the chance of loss". You may avoid suffering and sorrow if you take no risks and yes, if we assume the solvency of the government is a given, we can even avoid loss of principal on our invested money if we put 100% of it in FDIC insured CDs or money market accounts.

Most people understand intuitively that today they will actually lose purchasing power if they keep all or most of their money in CDs given the current interest rate environment. Why? Because the rate of inflation is outpacing even the most generous CD rates. That means you will be in essence going backwards with your invested dollars instead of gaining ground by finding suitable investments that will outpace inflation.

So why will people still avoid risk at any cost when it comes to their money? I believe the answer is different for each one of us. We are products of our upbringings and our life experiences. Many older Americans lived through or had parents who lived through the Great Depression. As a result, their parents and/or other relatives probably adopted frugal spending habits and/or a distrust of the stock market. We can't ignore those life experiences. Yet even if we are more risk averse than our neighbors it doesn't mean we are doomed to a life of CDs. We can become informed about risk and understand our own unique relationship with money.

Earl Nightingale who wrote ***The Strangest Secret*** told a story of a farmer who was out walking out in his field one day when he spotted a tiny pumpkin growing there. He also saw a jar lying nearby. He got an idea so he put the tiny pumpkin inside the jar. He came back a few weeks later and noticed that the pumpkin had grown inside the jar and no more. It could not grow beyond the confines of the jar.

If we want to develop a successful retirement plan then we need to grow beyond the confines of our life experiences. One way to do that is to learn. Eleanor Roosevelt said, "You gain strength, courage and confidence by every experience in which you really stop to look fear in the face.” The first step is to understand the root of the fear.

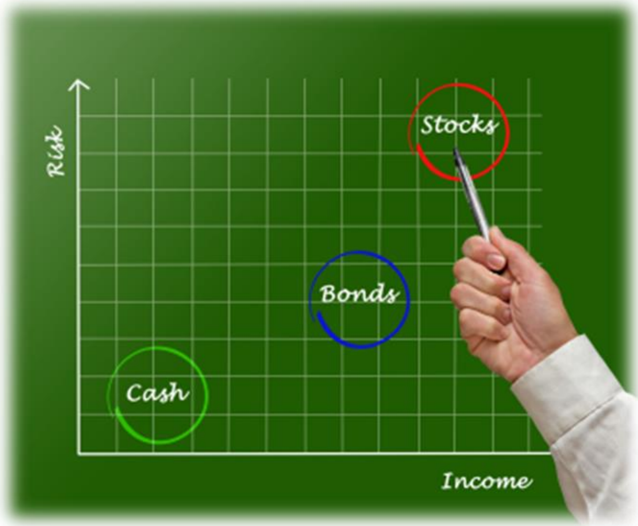
If taking risk is one of those fears then my hope is that this discussion on risk will provide you with the information you need to make informed and suitable investment decisions. You should not rely on someone else to make that determination for you. Each one of us has our own unique risk profile and it is on that basis that investment decisions should be made. Thank you for joining me in this discussion. I look forward to hearing from you in the near future.

Risk in the Investment World

Investing is often viewed as speculation like going to Las Vegas and gambling our money away on the roulette wheel. Others view investing in a similar way as savings. The reality is that investing combines speculation and savings. In Las Vegas you either win or lose, there is no in between. The odds are stacked against you. In the investment world while it is true you can lose your investment there are ways to mitigate your risk. You can gain an advantage if you become informed. We will discuss those “ways” later. People typically invest to achieve a financial goal. The risk they assume to achieve those goals is the subject of our discussion.

Modern Portfolio Theory (MPT) was introduced in the 1950’s and presented the concept that risk was “two-sided”. In other words, the greater an investment’s deviation from an anticipated return (either up or down) the riskier it was assumed to be. Today there is an updated version of MPT receiving attention. It called Post-Modern-Portfolio-Theory (PMPT). It focuses mainly on the risk of loss or the downside risk. How could PMPT be used? Think about your retirement. Many of us could spend 20-30 years in retirement so we need to count on our savings and investments to provide us with an income for a long time. So in the planning process we might make certain assumptions about the income we will need and then what investment return we need for our portfolio to sustain that 20-30 year income stream. PMPT uses statistical analysis to estimate the likelihood that the portfolio would fail to produce the income needed. You would make plans based on that likelihood. The mathematical calculations involved are beyond the scope of this discussion.

Risk and Return

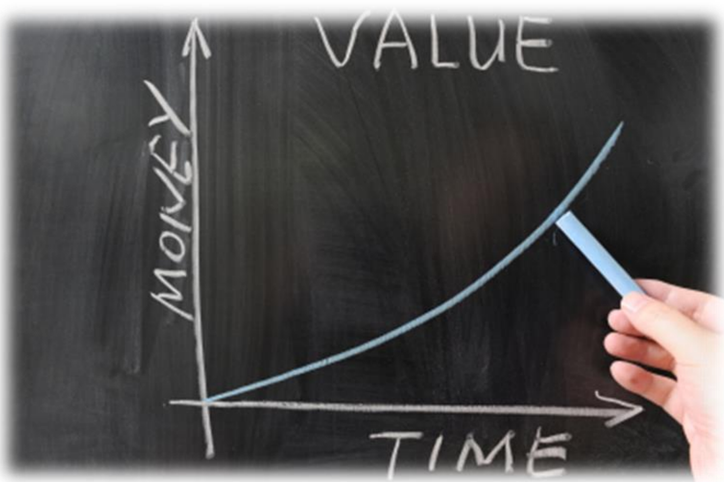


Risk and return are inversely related. In other words the higher the return needed the higher the risk you must assume. If you want a more certain outcome then you take on less risk and have to accept a lower potential return. You will hear this called the “risk-return tradeoff”.

From the graph at the right you can see the relationship between risk and return (or income as shown on the graph). In addition, you can see where some traditional asset classes fall on the graph. Stocks are more volatile so they have a higher income potential. Bonds are less volatile and cash is the least volatile. The same holds true for stock mutual funds and bond funds as well.

Risk and Time

When you invest you typically invest for a specific goal say college savings. So if you start a college savings account when your child is born you have 18 years to save. That is called your investment time horizon. In general the longer your investment horizon the more risk you can take. Again in theory you have more time to make up for any downturns that impact your investment. There is never any certainty that you won’t lose money but I think you can see what I mean. On the chart to the left the curved line represents the risk. As I go out on the time line, in theory, the more risk I can take.



What’s My Propensity for Risk?

There’s another bit of industry jargon you will hear, “propensity”. It simply means how much risk you can tolerate before you start losing sleep. If you can withstand a considerable amount of risk then you are referred to as “risk tolerant”. If you can accept very little risk then we call that being “risk averse”. Most people fall somewhere in between the two.

In this discussion I will show you how you can determine your own risk tolerance when it comes to investing. There are a number of tests out there and none are fool proof. It’s not an exact science because investing involves emotion. As I mentioned earlier our life experiences come into play as does the media, our friends and relatives, etc. As a result, your risk tolerance may change over time as your circumstances change. We will review your propensity in more detail when we look at the risk questionnaire.

How to Evaluate the Risk of a Specific Investment?

Here is where things get really complicated. I won’t go into the weeds here. Suffice it to say that this topic deserves its own eBook. Unless you are an experienced investor you probably won’t spend a lot of time analyzing specific investments. By that I mean the investment’s beta, alpha, standard deviation and so forth. Again, more industry jargon.

Systematic Risk

Each investment is subject to uncertainties that are associated with that type of investment. These are called ***systematic risks***. Real estate is an example of an investment subject to systematic risk. Think of the acronym PRIME if you want to remember systematic risks:

P – Purchasing power risk = risk associated with inflation

R- Reinvestment risk = the risk of having to reinvest your money at an inopportune time.

I – Interest rate risk = the risk of your investment being impacted by changes in interest rates

M –Market risk -=risk associated with the stock market i.e. Facebook and its rough initial offering

E –Exchange risk = risk associated with changes in foreign economies, governments, etc.

Systematic risks are things that affect the entire market and you simply cannot diversify since each of us does not have any control over inflation and interest rates for example. These risks can be mitigated but not eliminated.

Unsystematic Risk

This is risk that is specific to a company, industry or class of investments. Unsystematic risk is also called *diversifiable risk* because there are ways to minimize or diversify the risk of the investment. For example, let's say you are invested in Citibank because you like bank stocks. In order to diversify your risk you may choose to also buy stock in a public utility like Pacific Gas & Electric.

Investing in different industries is one way to diversify your risk. To further diversify your risk you should consider investing in different asset classes such as stocks, bonds, real estate and cash equivalents. How much should you invest in each class? We will answer that later.

How does one go about all of this risk analysis? My suggestion is to leave it to the professional money managers. A good financial advisor can assist you with this process of evaluating your personal risk tolerance as well as the risk of each investment that you are considering. If you are set on doing in yourself, the good news is that there is a wealth of material online and elsewhere. Just make sure that you have the time to sift through all of it. Most of the self-directed investment firms have online research libraries that you can access.

Analyzing Your Personal Risk Tolerance

Perhaps you have met with a financial advisor for the first time and at some point during the conversation the advisor says something like this to you, "So, what is your risk tolerance?" As you search your mind for an answer the one thing that keeps coming to the surface is, "Well, I don't want to lose any money." The advisor looks at you with some confusion as if to say, "Well, duh, none of my clients want to lose money." Instead he proceeds to ask you if you are a "conservative", "moderate" or "aggressive" investor.

Again, as you search for context the best choice of the three seems to be "conservative" so you emphatically state that "Yes, you are a conservative investor." Your reasoning is typically such because in your mind you equate "conservative" with "not wanting to lose any of your investment."

At that point the financial advisor proceeds to check the box marked "conservative" and he believes that he has fulfilled the requirements of his compliance department. In his mind he has determined your "risk tolerance". What you don't know is that you are still potentially miles apart in terms of accurately assessing your true risk tolerance. Why? Because your advisor's interpretation of "conservative" may be completely different than yours and unless he/she quantifies “conservative” you could end up getting talked into an investment that in your eyes is anything but conservative.

This has long been a dilemma facing the investment world as financial advisors and their clients and prospective clients often fail to get on the same page when it comes to how clients feel about money. Our industry is filled with jargon and acronyms and many times while the client or prospect is shaking their head in agreement they end up walking out asking themselves, “What just happened?”

So what’s the answer? Well, it’s really a three step process to truly understand your risk tolerance.

Step #1 – What is your relationship with money?

Getting in touch with how you feel about your investable assets is critical to solving whatever problem you are trying to solve with your money be it retirement income, leaving a legacy, getting more income now or saving for a child’s or grandchild’s education. The answers to these questions will help you get started:

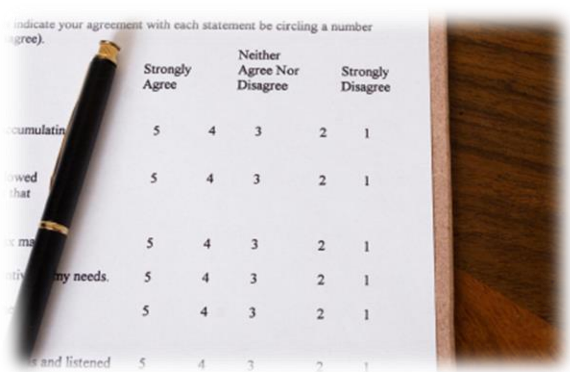
1. Describe your experiences working with financial advisors in the past
2. How do you feel about the volatility of the stock market?
3. What are your previous experiences investing your money?
4. How much can you afford to lose and still be able to sleep at night?
5. Do you have personal convictions that affect where and how you invest your money?
6. What is the most important factor to you in developing a working relationship with a financial advisor?

Step #2 – What should you know about the advisor you are working with or considering working with?

1. Does he/she have any complaints filed against him/her? (Go to FINRA.org and use the "BrokerCheck" feature)
2. Does the advisor work with people like you – feelings about investing, age, socioeconomic similarities.
3. What is the advisor's client service model – in other words how will you be treated after the sale?
4. Does the advisor sincerely try to get to know you and include you in the decision making process?

Step #3 – Does the advisor use an evaluation approach to determining your risk tolerance?

A true professional will use a survey type document to gain agreement on what your actual risk tolerance is. Make sure that you understand the output and that you agree.



What follows is an example of such a questionnaire-type form that I encourage advisors that I work with to use with their clients. It is used in conjunction with the ***Retirement Analyzer*** software program that is also an effective financial planning tool. One of the reasons that I believe this risk tolerance questionnaire is effective because:

1. It's fairly easy to understand
2. The output is goal oriented
3. It provides a recommended allocation model in conjunction with the stated risk tolerance. In other words it doesn't tell you where to invest.

The third point is especially important because you and your financial advisor will need to agree on what investment is aggressive, moderate, conservative, etc. For example, high yield corporate bonds are aggressive investments even though an aggressive investor may not think so.

To get a good idea of your risk tolerance, answer the questions below and keep track of the corresponding point total for each question. After you answer the last question, total all of the points and match the total with the appropriate risk model.

<u>Time Horizon</u> **How much time, in years, can you let your Assets Earmarked for Retirement grow, before you will have to begin withdrawals?**	**Points**
0-2 Years	0
3-5 Years	1
6-10 Years	2
10+ Years	3
13+ Years	4

Answers to this question will help us determine how long you might leave your money invested before having to use it in retirement.

Points_____________

<u>Approach to Saving and Risk</u> **How do you feel about Saving and Risk?**	**Points**
I do not want to see my principal amount decrease.	0
I cannot afford a significant loss to principal regardless of interest earned.	1
As long as my rate of interest stays ahead of inflation, I don't want the exposure to non - guaranteed principal investments	2
If I can make a moderate rate of interest on my investment, I can withstand some market fluctuation.	3
I want to invest for higher returns and I am willing to take on some risk.	4

Answers this question will help us determine your tolerance for risk.

Points______________

What would you consider reasonable interest earned on your assets earmarked for retirement?	Points
3%-4%	0
4%-6%	1
7%-9%	2
9%-11%	3
Greater than 11%	4

Answers to this question will help us determine your expectations for interest earned or rate of return.

Points______________

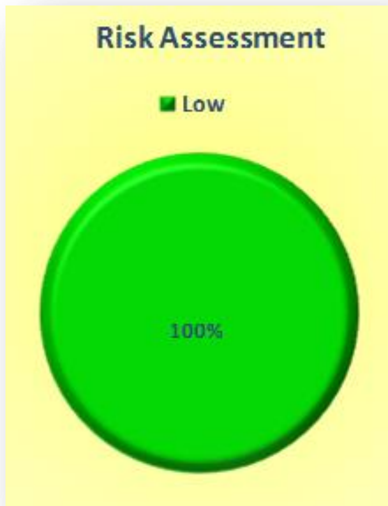
<u>Risk Tolerance</u> You've just made a $100,000 Investment. You are exposed to the following best and worst case scenarios. Which possibility would you choose?	Points
Best Case = $102,000 Increase = 2,000 Worst Case = $100,000 Decrease = $0	0
Best Case = $104,000 Increase = 4,000 Worst Case = $96,000 Decrease = $4,000	1
Best Case = $108,000 Increase = $8,000 Worst Case = $92,000 Decrease = $8,000	2
Best Case = $112,000 Increase = $12,000 Worst Case = $88,000 Decrease = $12,000	3
Best Case = $116,000 Increase = $16,000 Worst Case = $84,000 Decrease = $16,000	4

Answers to this question will help us further determine your risk tolerance.

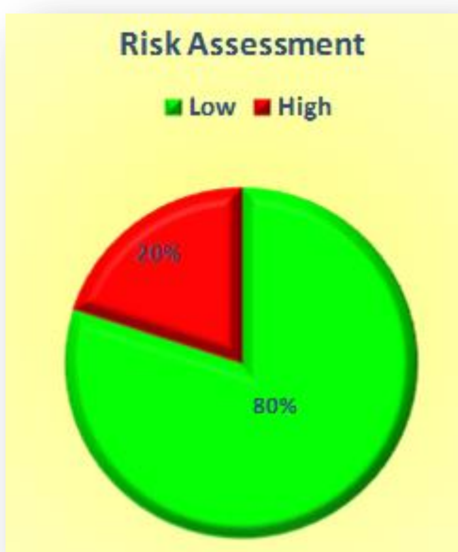
Points_______________

Client Total Points: ______________

0-3 Points – Low Risk
Highest concern id safety of principal
All funds allocated to guaranteed principal products

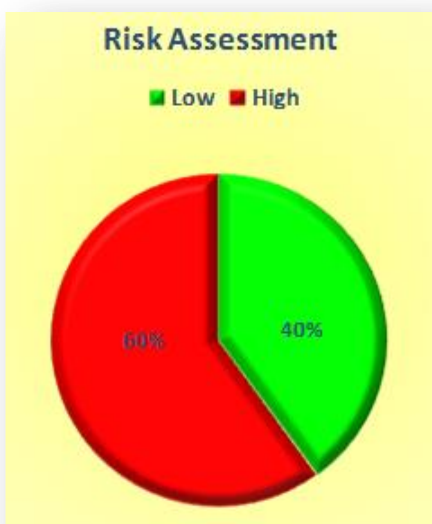


4-6 Points – Conservative
Highest concern is safety of principal
Large % of funds allocated to Low Risk

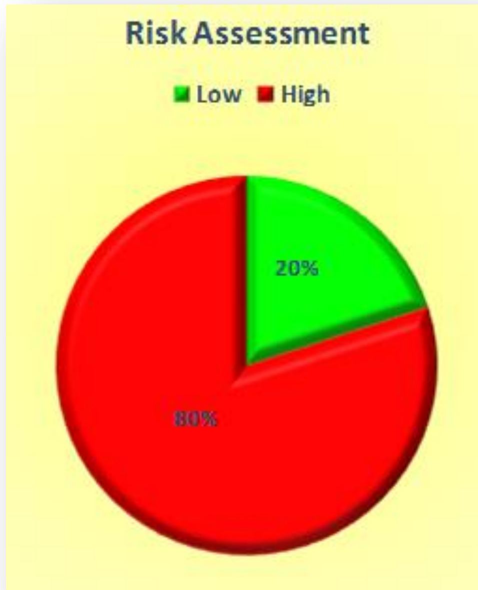


7-9 Points – Moderately Conservative
Primary goal preservation, secondary goal accumulation
Balanced allocation, slightly over weighted toward low risk

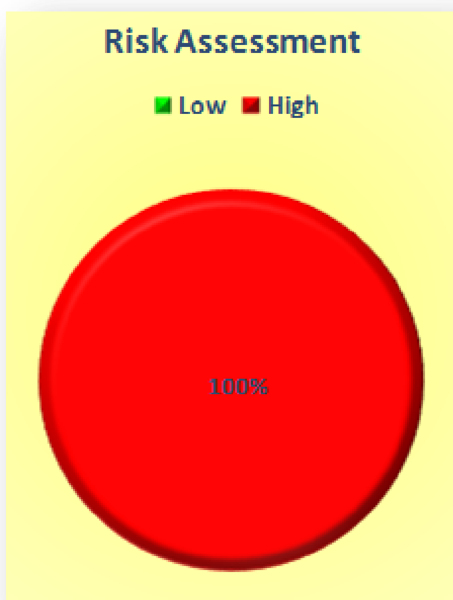
10-12 Points – Moderate
Primary goal is accumulation
Balanced allocation, slightly over weighted toward high risk



13-14 Points – Moderately Aggressive
Primary goal is accumulation
Most of portfolio is concentrated in high risk



15-16 Points – Aggressive
Most aggressive risk level
Potential to generate the highest returns



The pie-chart allocations are a starting point. The next step is to determine what asset classes will go in each section of the pie-chart.

For example, if you are a "moderate" investor with a 60/40 recommended allocation you will have to decide what investments will make up the 60% high risk and 40% low risk. If you have $20,000 to invest you might decide that you will invest your 60% high risk dollars in a high tech sector mutual fund and a Real Estate Investment Trust and your 40% perhaps in a blue chip stock fund and a municipal bond fund.

Where to invest your money is a topic of another eGuide/eBook. I look forward to helping you with the next step in your retirement planning journey.

Summary

It is my hope that this review of risk serves to help you make better investment decisions. Everyone responds to risk differently. There is no one size fits all approach. If any financial advisor attempts to categorize your risk without using an assessment tool, my advice is to politely excuse yourself and go find an advisor who does. There is too much at stake. You have to think about your retirement income and do everything in your power to make it last for your lifetime. A big part of that strategy is matching your investments with your risk tolerance.

John Wooden, the great UCLA basketball coach once said, “There is no pillow so soft as a clear conscious.” May you enjoy many nights of sound sleep and a long, prosperous and enjoyable retirement!

Disclosure for Risk Questionnaire

This tool is provided as an educational tool and is not intended to provide investment advice. All calculations are based on information provided by you and input provided by your financial professional. The analysis tool, charts and hypothetical illustrations are not intended to be representative of any specific financial vehicle and do not project or guarantee the actual results of any financial product or strategy. Prior to making any financial decisions you should obtain tax or legal advice from a qualified professional. Any guarantees offered within an insurance or annuity product are backed by the financial strength and claims paying ability of the issuer.

The risk assessment tool is an informational tool only, and is not intended to be a precise measurement of risk. This tool is provided to give you some indication of what your risk tolerance may be.

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