When Investing, Consider Your Age and Your Assets

What's Your Risk Tolerance?

by Alexandra Armstrong, CFP, and Christopher Rivers, CFP

After witnessing the market declines of 2008 and early 2009, many people were afraid to invest in the market. They declared themselves unwilling to take risk with their investments. But if they followed their emotions, they would have missed the ensuing nine years of market gains. As we write this column after the first quarter of the year, investors have witnessed the inevitable correction to market values. This causes us to revisit the topic of risk for investors.

Financial Risk Versus Emotional Risk

We think there are two basic ways of looking at risk: the amount of financial risk you can afford to take as well as the emotional risk you're willing to take. When figuring the financial risk you can afford to take, you should consider your age as well as the amount of assets. For instance, if you're relatively young and are a two-earner couple who doesn't spend all your income, you should be able to take more risk with your investments because you have more time to accumulate assets. Even if over the near term your investments don't work out as well as you'd hoped, you can make other investments in the future.

On the other hand, if you're retired and need the income from your investments, you can't afford to take as much risk. With retirees living longer than they did in previous generations, this has become more important. The size of your total assets influences your attitude toward risk as well. If you have more assets than needed to maintain your lifestyle, usually you're willing to take more risk with at least some of your investments.

Next you need to measure your emotional attitude toward risk taking. If your grandparents lost all their money in 1929, or if your father wasn't good at managing money, you may have trouble taking a risk with your own money. This is a very human reaction. It's important to realize that these negative family experiences can have a lasting negative effect on your own attitudes.

In addition, your attitude toward taking risk can vary over time based on your most recent experiences — either positive or negative — when you took risks. For example, if you lost money in the 2008-2009 decline, this might have prevented you from participating fully in the ensuing bull market. If your experiences with taking risks were rewarded in the past, you'll probably be more willing to take risks in the future.

Risk-Reduction Techniques

After you've examined how much risk you can afford to take and how much you're comfortable taking, you should focus on risk-reduction techniques. It's important to start with the basic premise that it's virtually impossible to avoid risk altogether.

For instance, when you cross the street, you run the risk of being hit by a car. But if you cross the street at a marked intersection when the light clearly indicates it's safe for you to walk, you've greatly lessened your risk of being hit. If instead you're jaywalking, you're taking more risk.

When investing, the first way you can control the negative impact of risk taking to some extent is by doing your homework. There's a difference between taking educated risks and speculating. Speculating is equivalent to betting at the racetrack by putting all your money on one horse with the name you like or the color of silks you prefer.

As a BetterInvesting member, you're familiar with this concept of educating yourself. A company might have a wonderful product, but you need to check out its competition, the amount of debt the company has, its history of profits and the relationship of earnings to the current market price before deciding to invest in that company's stock.

Another way to reduce risk is to diversify among different kinds of assets such as stocks and bonds. We've always had problems with artificial formulas that tie your asset allocation to your age.

One popular formula is subtracting your age from 100 to determine the percentage you should hold in stocks. According to that formula, if you're 65 years old you should have 35 percent in stocks and 65 percent in bonds. We think this makes no sense.

What we think is more important is to examine what kind of stocks you own and what kind of bonds you own. Investing in a blue-chip stock with an established market share and dividend/earnings record is quite different from investing in a startup company that pays no income. Investing in an international company that sells its products to consumers all over the world is different from a company in emerging markets with a limited track record.

In the bond area, investing in a corporate bond with a good credit rating involves less risk than investing in a high-yield bond for which the credit rating's much lower. You need to be aware, however, of interest rate risk. Bond prices decline when interest rates go up, as they're currently doing.

Another way you can limit your risk is to work with an experienced financial planner. Although this isn't necessarily a panacea, a professional can show you different

investment alternatives and explain both the risk and return potential of each choice. That way you can put together a portfolio that matches your risk tolerance. We explain to clients that there's no right or wrong attitude toward risk. What's important is that you're honest with yourself and your adviser as to what your risk tolerance is and that you construct your investment portfolio accordingly.

Also to be considered is that if you're married, consider whether you have different levels of risk tolerance than your spouse. This can lead to family conflict. You need to discuss this issue with each other and may have to make compromises. For instance, a spouse who's more willing to take risk might invest part of the portfolio in more aggressive investments than the partner does.

Conclusion

Surviving the 2008-09 stock market wasn't fun, but it did remind us of certain basic concepts. It's true nothing goes up forever, you should avoid being house poor or overmortgaged, you shouldn't spend all your income, it's important to have a rainy-day fund and you really need to investigate before you invest. In other words, there's some validity to all those maxims that financial planners have been preaching for years!

Although taking some risks with your investments is essential to making money, it's been our experience that you don't have to be a speculator to build wealth successfully over the long term.

Although it isn't always easy to do, we urge you to try to ignore the daily fluctuations of the market and adopt a slow, steady and consistent approach to investing. Our formula is quite simple — do your homework; buy good, solid investments; and don't let your emotions rule your decisions. But as a BetterInvesting member, you're already following this advice!

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Ms. Armstrong can't answer individual inquiries, but welcomes suggestions for future article topics.

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