A Financial Planner May Ask You to Examine Your Money Fears

Are You Willing to Take Risks?

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The dictionary defines risk as "the possibility of suffering harm or loss; danger." Before we went through the market decline of 2008-09 and the current global concern about sovereign debt, many people would equate taking risk as the possibility of making money, rather than the potential of losing money. Today, our perspective has changed.

Unlike measuring height or weight, there's no unit of measurement for risk tolerance. Your risk tolerance can be measured only relative to others on a constructed scale in much the same way an IQ is measured. Even the meaning of "risk" can depend on the situation. When individuals talk about the risk they experience in their financial affairs, they aren't talking about the same thing as investment researchers discussing the risk of a particular kind of investment.

As part of our financial-planning process, we ask our clients to complete a risk-tolerance questionnaire, but this only gives us an idea of the risk people are willing to accept when they take the questionnaire. We recognize that your risk tolerance can be easily influenced by recent events and your experiences. It's easy to rate yourself as an aggressive risk-taker when you think home values and stock prices are going up. The last few years, however, have caused many people to become more risk-averse.

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, your age as well as the amount of assets should be considered. 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.

But 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, particularly if you don't have pension income.

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, some new clients will tell us they're highly risk-averse, but they own some speculative investments. When we ask them about this apparent inconsistency, they reply that since these risky investments didn't work out well, they're now not willing to take a risk. Obviously, the reverse can be true. If your experiences with taking risks were rewarded in the past, you'll probably be more willing to take risks in the future.

After you've figured out how much risk you can afford to take and how much you're comfortable taking, you should focus on risk-reduction techniques.

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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 profits and the relationship of earnings to the current market price before deciding to invest in that company's stock.

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 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.

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.

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

Rank your own risk temperament on a scale of 1 (risk-averse) to 10 (willing to take a high degree of risk) and then make sure you communicate this information to your adviser.

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 some 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 is.

Surviving the 2008-09 stock market wasn't a fun experience, but perhaps there were lessons to be learned. Perhaps we learned the hard way that nothing goes up forever, that you should avoid being house poor or overmortgaged, that you shouldn't spend all your income, that it's important to have a rainy-day fund and that you really need to investigate before you invest. In other words, people might start believing all those maxims that financial planners have been preaching for years!

Although taking some risk 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. We urge you to try to ignore the daily fluctuations of the market and adopt a slow, steady and consistent approach to investing. Keep in mind the fable of the tortoise and hare!

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