RISK PROFILE

A look at portfolio risk profile components - tolerance, capacity and perception.

Abstract

A look at measures that go into defining your investment risk profile: risk tolerance, risk capacity and risk perception. Understanding your risk profile will help when deciding on how to allocate your portfolio to meet your investing objectives. Too much risk makes it harder to stay invested in a declining market and not enough risk might derail your long-range goals.

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Risk Profile

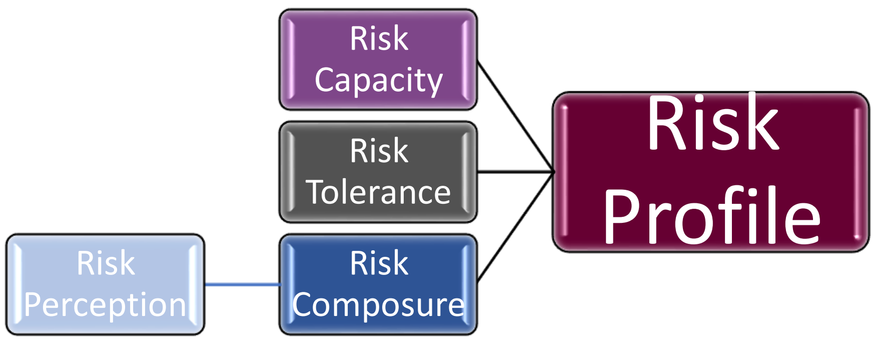
Your Risk Profile is comprised of your Risk Capacity, Risk Tolerance, Risk Composure and Risk Perception.

Risk Capacity is your ability to withstand a financial setback in the market and will vary over time with your personal situation.

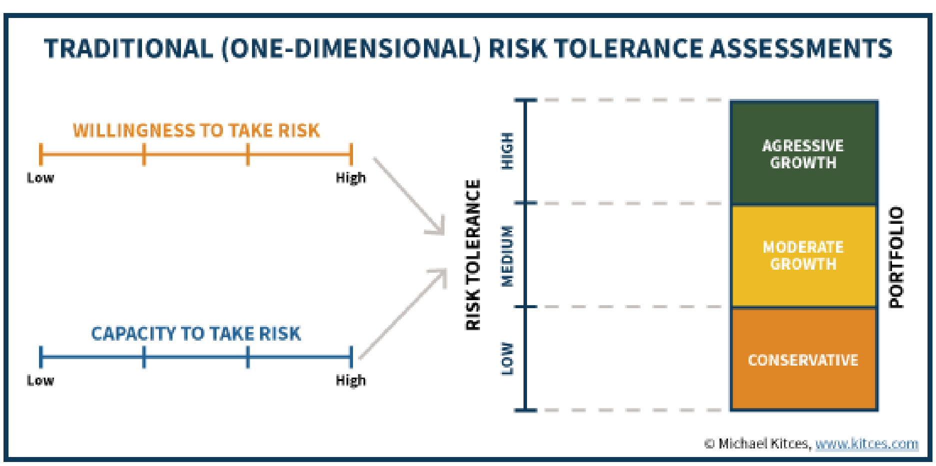
Risk Tolerance is how emotionally comfortable a person is with taking financial risk and tends to be static over time. It measures your willingness to tolerate portfolio volatility and how much of a decline you are willing to assume in order for a chance at higher returns.

Risk Composure is the ability to consistently understand and correctly perceive portfolio risks.

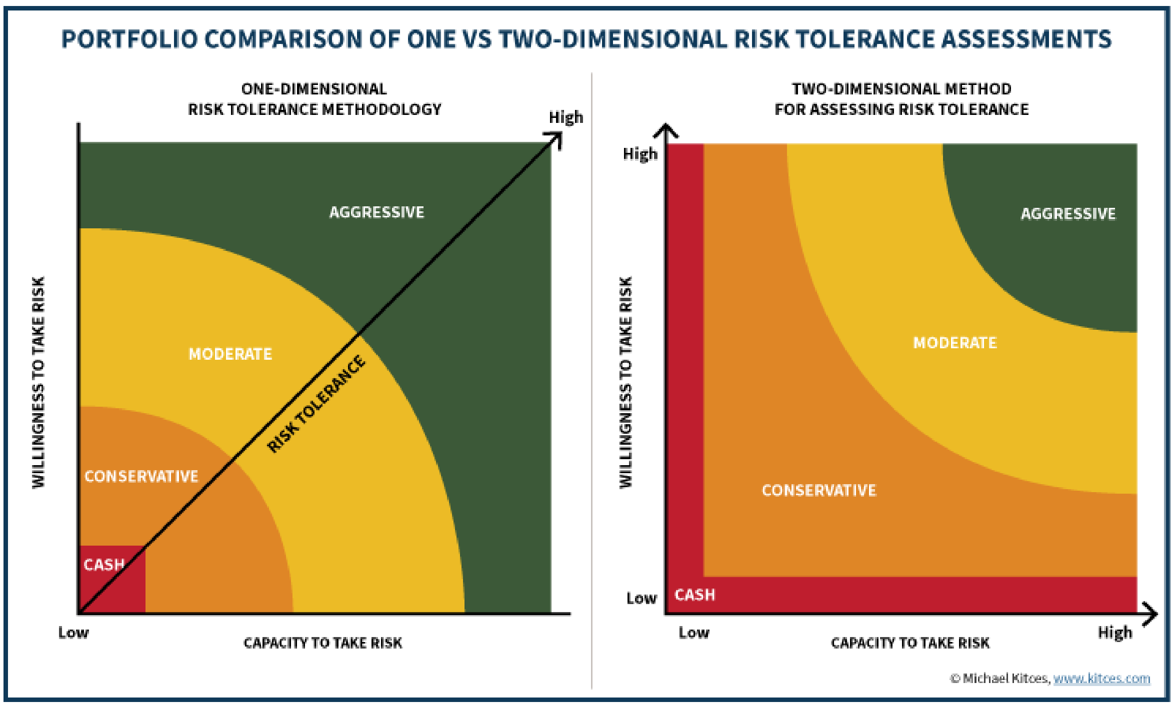
Perceived risk is the subjective belief (whether rational or irrational) about the chance of occurrence of a risk or about the extent, magnitude, and timing of its effect(s).



The traditional approach measured an individual's capacity to take risk and combined that with their willingness to assume risk to determine their risk tolerance.



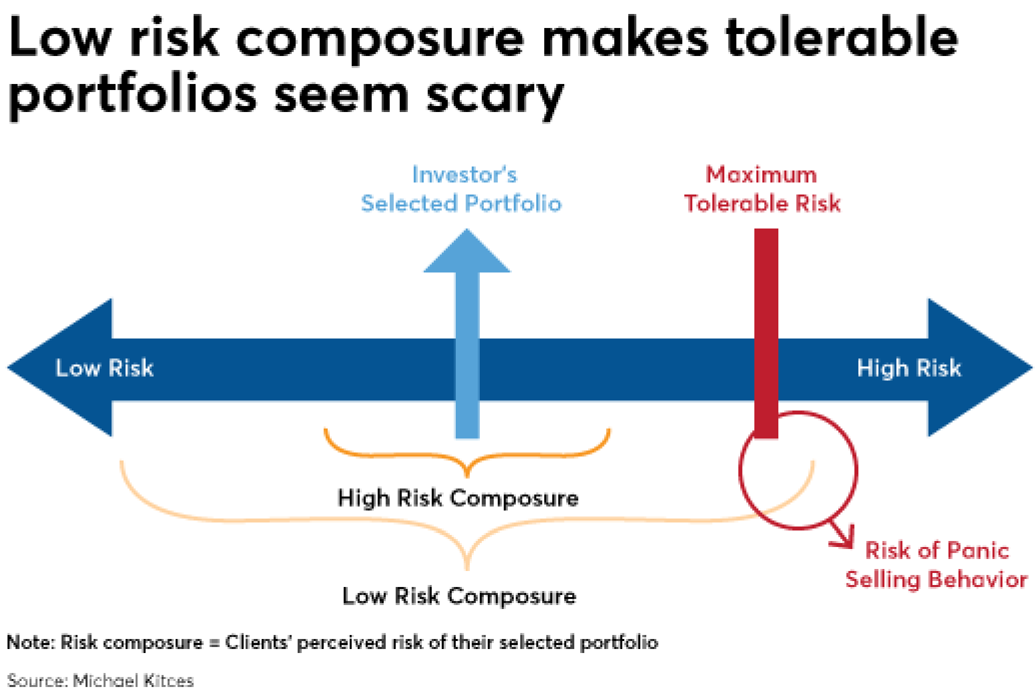
Portfolio misallocation is greater with a one-dimensional risk assessment because it combines both risk factors together. For example, one investor has a low-risk capacity score of 10 and a high tolerance score of 30 and another investor has a high capacity score of 20 and a risk tolerance of 20. They both have the same Risk Score, but their profiles are very different. By using a two-dimensional assessment and looking at the interaction of willingness and capacity when determining an individual's portfolio allocation, the chances for misallocation are reduced as shown in the following chart.



Risk Composure and Risk Perception

One factor that consistently derails an investment goal for some investors is their misperception risk. According to Michael Kitces, "Some clients are especially prone to misperceiving risks (and thus tend to make frequently-ill-timed portfolio changes). Or viewed another way, while some clients are quite good at maintaining composure through market ups and downs, others have poor risk composure."

While we have been discussing logical data points up until now, investors are not totally rational. Many investors lack the ability to consistently understand and correctly perceive the risks they're taking. Emotions overrule data. We overestimate small probabilities and underestimate large ones. According to authors Sara and Jack Gorman, "We particularly overreact to risks that are uncontrollable, have catastrophic or even fatal consequences." We overreact to risks we can't control (like the fear of nuclear accidents) and underreact to risks we can (like how we drive a car). Risk perceptions can arise from a combination of uncertainty (i.e. lack of knowledge) and the seriousness of consequences. Risk perception is highly subjective and affected by societal influences and cognitive biases: thus a particular hazard will mean different things to different people and in different contexts. It’s the investor’s ability to consistently understand and correctly perceive the risks they’re taking that really determines whether they are able to effectively stay the course. Understanding the biases that influence your perception of current risk to your financial situation involve your beliefs, attitudes, judgments and feelings, as well as the wider social or cultural values and dispositions. Risk perception is an idiosyncratic process of interpretation, a process of making sense of a complex world in order to plan, choose and act in that world.



Questions to Assess Your Current Risk Perception

1. Are you concerned about stock market risk? If so, why? If not, why not?

2. Are you comfortable with the plan we have in place to deal with this risk? If so, why? If not, why not?

3. What kind of risk keeps you up at night?