

RETHINKING RISK

Risk Tolerance = Ability + Emotion

Risk tolerance is one of the most important issues to consider when building an investment portfolio. And it may be one of the most misunderstood. Many investors believe risk tolerance is a reflection of their emotions, but the more important component is your financial ability to take risk. Your portfolio needs to suit both your personality and your pocketbook.

Key points

- 1 Emotions: important, but unreliable.** Investors' feelings about risk can change from day to day and can run counter to sound investment strategies.
- 2 Ability: based on facts.** Your true risk tolerance is grounded in your financial ability to take risk. This includes your time horizon, income, debt, liquidity needs, level of portfolio contributions and more. When you're pursuing financial goals as a household, your spouse's or partner's risk tolerance must be analyzed as well.
- 3 Intentional InvestingSM.** Over time, your risk tolerance will change – due to major life changes such as having children and also due to the passage of time. You need to take deliberate, intentional steps to make sure your portfolio continues to suit your situation. Visit with your financial advisor annually – or sooner, if you experience a major life event – to determine whether your investments are still appropriate for your risk tolerance.

1

Emotions: important, but unreliable

Accurately assessing your risk tolerance is critical because it sets the foundation for your portfolio. Your risk tolerance shapes your ideal asset allocation – how much of your portfolio is invested in stocks, bonds, commodities and cash. It also affects which fund managers you choose. Even within the same asset class, different fund managers can be more conservative or more aggressive.

Many investors measure risk tolerance primarily on an emotional level – how they feel about the markets and investing. The problem, however, is that emotions can fluctuate from day to day, and can run counter to sound investment strategies.

In one study, 113 business students filled out risk tolerance questionnaires from six major financial companies. The average similarity among each student's results was just 56%.¹ In other words, the chances were just greater than half that multiple questionnaires would yield the same risk tolerance profile for a single investor.

Why would an investor's risk tolerance score vary so significantly? The wording of the questions can be a factor, and the investor's mood can also play a role. For example, if you read a positive story about the markets in the news, you may feel differently about risk than if you read a negative story.

Fluctuating emotions often run counter to sound investment strategies. As stock prices go up, some investors may feel more optimistic – and they may be more willing to buy stocks. And as stock prices go down, investors may feel more pessimistic, and perhaps less inclined to buy stocks. To the contrary, a strategy grounded in facts, not emotions, would call for buying stocks when they're priced low and selling them when they're priced high.

Additionally, emotions may lead a cautious person to invest too conservatively in an effort to avoid losses. But, it's important to remember that investing too conservatively carries risks as well, namely that your portfolio might not grow enough to reach your financial goals, or even keep pace with inflation.

So, while it's important to feel comfortable with your portfolio, it's critical to make sure that your decisions are based on solid facts.

Emotions can vary from day to day and can run counter to sound investment strategies. They should not fully dictate your portfolio decisions.

BOTTOM LINE ←

¹ Source: "Your Money and Your Brain: How the New Science of Neuroeconomics Can Help Make You Rich," as quoted in Risk Tolerance Can't be Measured Like a Shoe Size, Horsesmouth.com, Dec. 5, 2007.

2 Ability: based on facts

Your true risk tolerance is grounded in your financial ability to take risk, rather than your emotional willingness to take risk. The chart below highlights several of the financial factors that affect your risk tolerance. When you're pursuing financial goals as a household, your spouse's or partner's risk tolerance must be analyzed as well. That means answering all of the same questions and creating a risk tolerance profile for the household.

How much risk can you take?

Consider these factors and how they interact

Lower ability to take risk	Higher ability to take risk
Time: <ul style="list-style-type: none"> Short time horizon (a few years before your financial goals) 	Time: <ul style="list-style-type: none"> Long time horizon (many years before your financial goals)
Level of Portfolio Contributions: <ul style="list-style-type: none"> Low relative to your financial goals 	Level of Portfolio Contributions: <ul style="list-style-type: none"> High relative to your financial goals
Income and Savings: <ul style="list-style-type: none"> Low to moderate income Low income stability Low job security Low savings rate 	Income and Savings: <ul style="list-style-type: none"> Moderate to high income High income stability High job security High savings rate
Other Factors: <ul style="list-style-type: none"> High debt levels/ratios High liquidity needs (for example, may need to withdraw funds from the portfolio in an emergency) Underinsured 	Other Factors: <ul style="list-style-type: none"> Low debt levels/ratios Low liquidity needs (for example, would not need to withdraw funds from the portfolio in an emergency) Adequately insured

One area that is often underanalyzed by investors is their income. The chart below demonstrates how the nature of your income may affect your risk tolerance.

Analyzing Your Income

Consider these factors

If your job is then your risk tolerance may be
In a cyclical industry, such as financials, energy or industrials	lower
Compensated through a balance of base salary and variable factors (bonus, commission, overtime, stock options)	lower
Compensated mostly through a base salary	unaffected
Secured through a contract or by tenure	higher

For illustrative purposes only. Investors should consult their financial advisor about their personal income and risk tolerances.

Another area to consider is your level of portfolio contributions. Many investors pursue more risk when they're underfunding their portfolio – seeking higher returns to make up for their inadequate investment. But if you're underfunding your portfolio, losses can easily jeopardize your goals, reducing your ability to take risk. In short, you can't solve a funding problem by taking on more risk.

True risk tolerance is grounded in your financial ability to take risk, which is measured by your time horizon, level of contributions to your portfolio, income, savings and more.

BOTTOM LINE

3 Intentional Investing

Your risk tolerance sets the foundation for your investment portfolio. It shapes your ideal asset allocation and can also affect which fund managers you choose.

But your risk tolerance is not static. Life changes such as having children, caring for aging parents, inheriting a windfall or suffering a layoff all affect your risk tolerance. Any event that changes your income, debt, financial goals, portfolio funding levels or time horizon should trigger a talk with your financial advisor.

Even if you haven't experienced any major changes, your risk tolerance will naturally change as time goes by. Generally, the less time you have before you reach your financial goals, the lower your risk tolerance becomes, because your portfolio doesn't have as much time to recover losses. Therefore, you should visit your advisor annually. Together, you and your advisor can take deliberate, intentional steps to make sure your portfolio continues to suit your situation.

NOT FDIC INSURED | MAY LOSE VALUE | NO BANK GUARANTEE

Note: Not all products, materials or services available at all firms. Advisors, please contact your home office.

Asset allocation does not guarantee a profit or eliminate the risk of loss.

All data provided by Invesco unless otherwise noted.