EXPERT CONTRIBUTOR

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What is Your Appetite for Investment Portfolio Risk?

By Rich Groff II, CFP

How would your stomach handle your investment portfolio when it reads $770,000 and just yesterday it was $1,000,000? You have lost $230,000 in 1 day and worse yet you're in retirement and now withdrawing 6% a year (or $60,000 Annually) of your portfolio for living expenses which is now nearly 8%!

For those of us that have been around for a while, we can vaguely remember October 19, 1987, when the Dow dropped 23% that day. More recently, most of us can remember September 29, 2008, when the Dow had a record-breaking drop of over 777 points to close at 10,365. The Dow continued to drop to a market low of 6,443 on March 6, 2009, having lost over 54% of its value from its October 9, 2007 high. This can equate to a lot of fear and emotions that can steal from our peace of mind and result in unrest and heartache.

One thing I've learned since I've been working with people since 1989 is that risk should not be stereotyped. Oh, but it has and often times by one's age. Rule of 100 says you should hold the same percentage of equities that is equal to 100 minus your age. In other words, older people should be more conservative and younger more aggressive. Then to further complicate things we throw in words like "moderate" or "moderately conservative" but what does all this mean and how can you actually measure it so one's personal risk matches one's portfolio's risk?

Over the years many of the psychological or qualitative questionnaires I've provided to ascertain one's risk tolerance fell back to the old stereotype of age and our research team has found that these assumptions are often dead wrong. In fact, the data shows that nearly 40% of people fall outside of their stereotypical age-based risk tolerance and therefore they are allocated wrong as a result. Rather a quantitative and objective approach to risk (or risk preference) is built upon a mathematical foundation: decades' worth of behavioral economic studies culminating in prospect theory, the leading economic theory of risk-reward decision-making that won the Nobel Prize in Economics.

With a quantitative risk questionnaire, a person can focus more on the actual dollar amounts that they have to invest. Thus, they are more likely to capture their actual Risk Number™, the quantitative measure of risk, based on their real investments rather than abstractions. The problem with most psychological or qualitative risk questionnaires is that they are inherently subjective. At some point in the process, someone must weigh the various answers to come up with a qualitative score which is then their estimated risk tolerance.

Why does it even matter to be able to measure one's risk and then make sure it matches their portfolio? Well because it has cost investors a lot of money over the years when they don't match. Research performed by Dalbar Inc., a company which studies investor behavior and analyzes investor market returns, consistently shows that the average equity investor earns way below average returns. For the 10-year period ending December 31, 2017, the S&P 500 earned an annualized 6.95% or nearly double the investor's return of 3.64%. Even worse, over the trailing 30-year period the investor gained a hair below 4% whereas the same index gained a bit more than 10% which is a huge margin and a lot of money lost. In reality had the person's risk appetite matched their portfolio's risk then they would have had a greater tolerance for the volatility and thus greater ability to stay the course and not panic by selling at the worse time (lower) and then buying back at the worse time (higher).

You can discover what your Personal Risk Number™ is (based on a scale of 1-99) by going to our website at www.RichGroff.com and taking a Complimentary Test and the results will then be emailed to you immediately upon completion. An actual client case study is there too in which they took this risk assessment test to discover their actual risk tolerance (aka "appetite") was a Risk Number™ of 29 when in fact after further analysis we discovered their portfolio was more than twice of what they currently felt comfortable with! You can learn - and gain - so much by knowing your Personal Risk Number™!

Rich Groff II, CFP is a 3rd generation Certified Financial Planner and resident of Flathead Lake with offices in Polson (across from Pure West Realty) and Peoria, AZ servicing clients throughout the United States since 1989. You can direct questions or inquiries to Rich@legacyplan4u.com or call 1-888-858-4996 Ext. 119.