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Financial Planning
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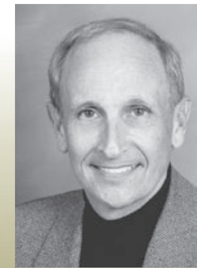
Portfolio Management



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Do You Know Your Investment Risk Tolerance?

It is important to periodically evaluate whether we are taking the right amount of risk in our investments. The subject can be confusing because, on the one hand, risk-taking resides at the heart of capitalism and is responsible for a large part of the growth of the economy. However, on the other hand, we each want to sleep well and be good steady providers for our families.

What is risk?

Basically, it is the chance of things not turning out as expected.

When I begin working with a new client, I ask them to complete various risk assessment forms. I call this an evaluation of their *"internal" risk tolerance profile*. One of the key questions is simply, "What is the maximum downward fluctuation in your investment portfolio with which you would be comfortable?" This is a *subjective* evaluation on their part regarding the amount of risk they can tolerate without reaching a moderate to high level of discomfort. This is valuable information because the person knows their own past experiences involving risks and how that affected them. However, this self-evaluation is also skewed by something called a "*recency bias*". This means that their recent experiences strongly influence their attitudes toward risk. If I were to ask an investor in December of 1999 what their risk tolerance was, they probably would have responded that they had a *high* risk tolerance. After all, they had had many sequential years of 20% to 30% returns in the stock market with no down years. However, if I were to ask an investor in December of 2002 about their risk tolerance, they probably would respond that they had a *conservative* to *moderate* risk tolerance. That's because they had a recent memory of a stock market that sustained substantial losses two or three years in a row.

The other part of my evaluation is for *"external" risk factors*. These are more *objective* and include 1) age, 2) other risks you currently face in your life, and 3) the investment goals you want to achieve over a specified time frame.

1) Age: As we mature through the life cycle, it is appropriate to take less investment risk. During later years, it is important to maintain a more stable balance of capital often made up of a higher percentage of fixed income investments to provide earnings during the retirement years.

2) Other risks: A person who is a small business owner is probably taking more risk and does not have the same financial security as someone who is a corporate or government employee. Some people might also have high-risk real estate investments at certain times in their lives and therefore might be better off lowering their risk in the stock market at those times.

3) Investment goals: What goals have you set in your financial/retirement plan for average returns on investments, and over what period of time? How does this relate to the 50-year average annual stock market returns? Are these goals commensurate with your personal risk tolerance? Can these goals be achieved within the *appropriate risk* parameters?

We need to remember that it is not only our personal *risk tolerance* that we want to consider, but we also want to ask ourselves, "What is the *appropriate risk* to take?" Therefore, if a person is taking significant risk aside from his or her investments, it may be appropriate to lower the portfolio risk in order to balance out the risks taken in other areas.

Risk Management

This is the process of bearing the risk you want to bear, and minimizing your exposure to the risk you do not want. With investments, there are various ways of doing this such as through 1) diversification, 2) a strategy of tactical asset allocation changes, and 3) beta coefficients.

1) *Diversification* is achieved by including numerous asset classes in the composition of a portfolio. Assets in the various classes will have different beta coefficients and will hopefully also have different correlations, and therefore provide different risk and volatility profiles.

2) *Tactical asset allocation changes* can be a part of the overall portfolio strategy in order to manage risk. This is the process of shifting asset classes to benefit from the cyclical aspect of the stock market in general or the asset classes specifically.

3) *Betas,* also known as beta coefficients or beta factors, are a popular analytical tool relied on by investors, portfolio managers, and market analysts to measure the volatility or risk of stocks and mutual funds. A *beta* measures the extent to which the price of a given stock or mutual fund varies with respect to the market as a whole. The stock market's beta is represented by "1.0". Stocks or mutual funds that, on average, rise and fall with the stock market also have a beta of "1.0". A stock or mutual fund with a beta greater than 1.0 indicates that if the market rises or falls, the stock or mutual fund fluctuates more than the market (up or down). A stock or mutual fund with a beta less than 1 indicates a stock that is less volatile than the market. For example, a beta coefficient of 0.5 indicates that the stock or mutual fund will move one-half as much as the market, either up or down.

It is critical that your portfolio match up with your risk profile. When you have time, look over your investment portfolio and see how it measures up to your own risk tolerance evaluation. Or, call and I'll be happy to review your portfolio with you.

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