



## What is 'Risk Tolerance' Really?

Dictionary.com describes **Risk** as “the hazard or chance of loss” and **Risk Tolerance** as “the degree of uncertainty that an investor can handle in regards to a negative change in the value of their portfolio.”

What if we combined these two definitions? Then we'd have a definition for risk tolerance that reads like this: “The degree of loss that an investor can handle in regards to a negative change in the value of their portfolio.” **And, this makes sense to me.**

However, when you substitute different meanings, you get confusion which leads to fear; which leads to lack of control; which leads to even more fear and financial decisions based on fear of loss, or worse – desperation. None of these will help either the individual investor or the advisor trying to help the investor, nor the market swings that are so susceptible to investor psychology.

We want to create wealth – not fear. In order to create wealth, you have to have confidence, which comes from a sense of control.

**What makes NO sense to me** is the tighter and tighter regulations for investment accounts and the continual ‘enhancement’ of the account opening documents that are intended to help protect the investor and provide an investment advisor with insight into the investor’s personal preferences and financial situation. I don’t understand why it is so difficult to bring the personal values and priorities into the discussion about investing.

Rather than impersonal phrases that have mixed meanings about risk tolerance and rate of return expectations and ‘common financial goals’, it seems to me that an investor’s key criteria for taking control over their investments while working effectively with an investment advisor isn’t a complicated, lengthy and impersonal documentation process, but a better understanding of some key personal preferences in areas such as:

1. Why do I want this investment?
2. What about the investment is attractive to me and why?
3. What criteria am I relying on to make my investment decision?
4. When will I get out of this investment – price, timeframe, fundamental changes to the investment itself?

5. How will I monitor it?
6. What amount of my total investment am I really prepared to lose?
7. What is the impact of that loss to my life?
8. Who is helping me make the decision to buy, to monitor the investment and the decision to sell?
9. What about this relationship is appealing to me and why?
10. What is their responsibility and what is my responsibility in the process?

**To understand risk tolerance, you have to understand yourself. By doing so, you learn to take control of what might otherwise seem uncontrollable.**

If you know that you are relying on the advice of your advisor as your primary decision making criteria for buying, holding and selling investments then you have to take control of what you can, a key component being your comfort level with loss. This is the amount of money you could conceivably lose before your life would be affected either because the loss forced you to alter your lifestyle negatively, or because you couldn't sleep worrying about what you should do.

This means that if you answered the question about risk tolerance and described yourself as a moderate investor, then this would likely be interpreted to mean that you could withstand a 15-25% drop in your portfolio value – meaning you have said that 'the degree of loss you can handle in regards to a negative change in the value of your portfolio' is 15-25%; meaning that if your portfolio (or individual investment if that's what you're looking at) dropped below that stated figure, you have already predetermined this to be the maximum you could comfortably lose.

**Your stated risk tolerance is really your predetermined exit plan for your investment.** When you were in an unemotional state, you made a decision about when you would sell your investment. This means that if you're at that point now and questioning what to do, the way to take back control of your money in a market that doesn't seem very controllable to the average investor is to:

- First, revisit your account opening documentation for your risk tolerance (a.k.a. exit plan).
- Second, if you're not there yet, then sit tight and revisit the consequences and plan with your investment advisor – see if there's a better fit for your current situation.
- Third, if you are at or below your tolerance point, then why are you still hanging on? Are you just afraid to take a loss? Are you holding on 'until it comes back'? Remember, there are opportunity costs to doing something as well as not doing something, and perhaps you need to consider some other options given the current economy? If the basis for the investment is still sound then was that one of your original criteria for determining when you

would sell? Likely, not for most investors, so what you have to work with is what you can be in control of and that is price and your personal comfort level with loss.

- Fourth, shift your focus away from the percentage of loss, or actual dollar figure lost and instead relate everything to its relationship to income, both your current income and your income for tomorrow.

I've used this example before, and will again, because it **says a lot for the importance of these concepts in real dollars and cents**: If you invested \$100k and said you have a 10% risk tolerance, you have said that if your \$100k dropped in value to \$90k, you would sell because you were not comfortable losing more than \$10k. A critical figure in assessing this is to also understand that the \$100k portfolio invested at 8% for 20 years would provide a monthly income of \$836.44. And the \$90k portfolio invested the same way would provide \$752.80 per month. The difference between the two portfolios is \$83.64.

So my questions to you as it relates to determining risk tolerance are these: **What is 'the degree of loss (as it relates to income) can you handle in regards to a negative change in the value of your portfolio?'** Or, what is the impact of that \$83.64 and where else can you find that money?"

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