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Risky business: Gauging tolerance of market volatility

Sarah O'Brien
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If someone asked if you'd rather see a $10,000 investment be more likely to double in 10 years than in 24 years, you'd probably say 10. But if you were asked if you'd be OK watching that investment drop significantly several times in that 10 years, you might reconsider.

That basic comfort level with the stock market's volatility is called risk tolerance. And when it comes to investing, it matters more than you might think.

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"Can you sleep at night no matter what the [stock] market does?" asked Laurie Siebert, a certified financial planner and senior vice president at Valley National Group. "If it makes the person restless, they might not have a lot of risk tolerance to be in the market."

And if they have zero risk tolerance and it is improperly applied, they might make a key investing mistake: allowing emotion to dictate their choices.

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A 2007 academic study out of the University of Nebraska-Lincoln showed that individual investors lose roughly 1.5 percent annually from a tendency to pull money out of stock mutual funds following a significant market drop, although that is precisely when stocks are cheaper.

Indeed, David Jackson, a CFP and advisor with Waddell & Reed, points out that when the behemoth Fidelity Magellan Fund was averaging double-digit returns in the 1980s and 1990s, many go-it-alone investors didn't reap the benefits.

Risk affects allocations

"Average investors were getting in and out of that fund at the wrong time," Jackson said. "The fund would go up, and they'd jump in.

"It would go through a rough cycle, and they'd jump out."

Risk tolerance is an important contributor to an investor's asset allocation. That is, the specific investments—ranging from the safety of U.S. bonds to riskier things, like small growth stocks—that comprise your portfolio should be a reflection of the risk tolerance involved.

"The best thing you can do is not react" to market fluctuations, Jackson said.

A key component of risk tolerance should be the time duration you expect to have the money invested. Most investment goals fit into one of three time frames: short-term (three years or less), medium-term (three to 10 years) and long-term (anything beyond 10 years).

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Obviously, for 20-somethings, retirement is a long-term goal and generally is considered one worthy of involving more investment risk because of that kind of time horizon. Those same 20-year-olds, however, might instinctively have a lower risk tolerance due to witnessing the 2008-2009 market crash and its effect on their parents' savings or their own college funds.

That disconnect between risk aversion and time duration can ultimately mean a huge difference in portfolio growth over decades, based on historical returns of the stock market (generally viewed as about 7 percent annually).

The flip side, however, would be if your time horizon is short. If you're saving for a down payment on a house and will need the money in, say, two years, having an overly risky portfolio is unwise.

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"You take risk when you have time [on your side]," said Waddell & Reed's Jackson. "You don't take any risk when you don't have time."

Specific goals—such as the above examples of saving for retirement or for a house down payment—are another part of determining risk tolerance.

Mary Ballin, a CFP and senior financial planner with Mosaic Financial Partners, said investors' goals are sometimes conflicting.

"You could have, say, [a retired person] who doesn't want any risk," said Ballin, explaining that means the person's portfolio will be earning very little income because of the safety of their investments.

Impact of events

"But then that person wants to take a $50,000 trip around the world," Ballin said.

Sometimes events throughout an investor's life occur that change an investor's risk tolerance, such as a job loss, impending retirement or even world events. It could be that Russia invades Ukraine, terrorists strike again somewhere in the world or there are fears, even, of a "zombie apocalypse."

Living through a market crash can scar a person's risk tolerance.

"Just looking at how people handled [the crash in] 2008 is a big indicator of their risk tolerance," Ballin said. "How did you react? Did you sell all your securities? Did you leave them alone? Or did you buy into the market and see it as a buying opportunity?"

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>
> -Mary Ballin, senior financial planner with Mosaic Financial Partners

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One tricky thing about having very low risk tolerance is it also means having your money in very safe investments, where sometimes their rate of growth can actually trail inflation.

"Inflation can eat into that money," said Siebert at Valley National Group. "And some expenses might even [outpace] inflation—like medical expenses—and that eats into that money even more.

"Sometimes those who are risk-averse are also the ones most impacted by inflation," she added.

Conversely, sometimes advisors have to rein in a client's risk tolerance a bit.

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"Maybe it's that a client's risk tolerance is they can swing from the chandelier and never take Pepto-Bismol," Ballin said. "But then I can show them that to reach their goals, they don't have to take on so much risk."

She said that for some clients who really want to invest in something very risky, her firm will carve out a sliver of the portfolio to dedicate to that desire.

"That kind of lets them feed that itch," Ballin said.

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