Step 3 - Assess your personal investment return and risk tolerance preferences

Category : Financial Planning -- 10 Personal Steps in the Right Direction

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Assess your personal investment return and risk preferencesStep 3 of 10 Financial Planning Steps in the Right DirectionCLICK HERE TO READ THE SKILLED INVESTOR's OTHER ARTICLES ABOUT THESE "10 FINANCIAL PLANNING STEPS IN THE RIGHT DIRECTION."   Investors with different levels of risk tolerance are more satisfied with investment strategies that are better aligned with their risk preferences.Differences in investors' personal risk tolerances mean that more risk-averse investors are personally more satisfied with a lower risk portfolio despite its lower expected returns. Less risk-averse investors are more satisfied with portfolios characterized by higher risk and higher expected returns.   When defining a personal investment strategy and before making related decisions, it is important for individuals to assess their personal risk tolerances relative to other investors. Investing involves risk, and there is no way around it. Investing means that the investor is willing to incur risk in exchange for the possibility of a higher payoff. An investor’s relative risk tolerance is the primary decision in his asset allocation strategy.   Individuals are not investing, unless there is a chance to lose some of or the entire price paid for a security. Rational investors expect increased returns for taking on increased risk. True investors are all assumed to be risk-averse versus risk-seeking. Market prices of securities reflect the current risk consensus, and investors have rational expectations for positive risk-adjusted payoffs. Investing is not like traditional gambling, where the expected average payoff is negative.   Differences in risk tolerances mean that more risk-averse investors are personally more satisfied with a lower risk portfolio despite its lower expected returns. Less risk-averse investors are more satisfied with portfolios characterized by higher risk and higher expected returns. Investors with different levels of risk tolerance are more satisfied by the expectations associated with investment strategies that are better aligned with their risk preferences.   Everyone would like higher returns, but only some are able and willing to live with the greater risks that are associated with a potential for higher returns. However, there are no guarantees in investing. All apparent “guarantees” themselves have a price and risks. Because investing is inherently risky, individuals should understand their probable response to risk factors that actually do materialize. Risk tolerance is an issue of personal psychology and will determine whether an investor will adhere to and sustain an investment strategy during difficult times. When markets are performing poorly and fears are high, an inappropriate alignment between an individual’s personal portfolio risk or volatility and his or her tolerance for that risk or volatility can be very costly.   In such circumstances, investors may take actions, which are appropriate to their personal psychology. However, these actions may be highly inappropriate for the current financial market situation and their long-term financial goals and welfare. For example, some investors panic and sell when they do not have to, only to see the market recover later. Portfolios with different risk and return characteristics are simply better for different investors depending upon their tolerance for investment risk.   While there are a variety of approaches to the measuring relative investment return and risk preferences, simple and brief written surveys often are not be sufficient. Individuals also need to assess their emotional and behavioral tolerance for risk relative to the average person holding investment assets. This self-assessment process is not easy. Individuals need to reflect upon personal real-life financial and other situations from their pasts that involved significant risks and rewards. Individuals often are good judges of their likely behavior in the face of investment risks that might actually materialize. However, they are often not good at assessing the likelihood of risks occurring. A truly competent and objective adviser can aid in this process.   An individual’s risk tolerance also needs to be compared to other investors. This is one of the hardest parts of personal investment decision making, since virtually all other investors are themselves averse to taking risks. The challenge is to gauge risk tolerance relative to others and then to adopt an investment strategy that reflects that relative risk tolerance.   The asset allocation of the average investor’s portfolio serves as a baseline. An investor would not wish to be talked into an overly aggressive and uncomfortable strategy that would be difficult to sustain through difficult times. Conversely, an investor would not wish to adopt an overly conservative strategy. Conservativism may feel more comfortable, but it tends to require higher savings rates to build up needed investment assets.

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