

Risk Tolerance: Facts Should Trump Emotions



If you read a positive story about the markets in the news, you may feel differently about risk than if you read a negative story. But fluctuating emotions often undermine prudent investing.

Risk tolerance is one of the most important issues you'll consider when building your investment portfolio. But it's often misunderstood. While many investors believe risk tolerance is a reflection of their emotions, the more important component is your financial ability to take risk. Your portfolio needs to suit both your personality and your pocketbook.

Emotions: Important, but Unreliable

Your feelings about risk tolerance – how you feel about the markets and investing – can change from day to day and can run counter to sound investment strategies. That's why it's important to accurately assess your risk tolerance, which sets the foundation for your portfolio and shapes your ideal asset allocation – how much of your portfolio is invested in stocks, bonds, commodities and cash. It also affects which fund managers you choose.

Many Investors Measure Risk Tolerance Primarily on an Emotional Level

As stock prices go up, some investors may feel more optimistic – and more willing to buy stocks. Likewise, as stock prices go down, investors may feel more pessimistic and perhaps less inclined to buy stocks.



Additionally, emotions may lead you to invest too conservatively in an effort to avoid losses. But, it's important to remember that investing too conservatively carries risks as well – your portfolio might not grow enough to reach your financial goals or even keep pace with inflation. So, while it's important to have your portfolio in your comfort zone, it's critical to make sure that your decisions are based on solid facts.

Your true risk tolerance is grounded in your financial ability to take risk, not your emotions about risk.

How Much Risk Can You Take?

Here's another consideration: You can't solve a funding problem by taking on more risk. Many investors pursue more risk when they're underfunding their portfolios – seeking higher returns to make up for their inadequate investment. But if you're underfunding your portfolio, losses can easily jeopardize your goals, reducing your ability to take risk.



Lower ability to take risk

- + Shorter time horizon
- + Lower savings relative to financial goals
- + Higher need for liquidity

Higher ability to take risk

- + Longer time horizon
- + Higher savings relative to financial goals
- + Lower need for liquidity

Next Steps

Take these steps to make sure your portfolio reflects your risk tolerance over time.

- + When you're pursuing financial goals as a household, your partner's risk tolerance must be analyzed as well. This means answering all of the same questions for both of you and creating a risk tolerance profile for your household.
- + Visit with your financial professional annually to make sure your investments remain appropriate for your risk tolerance, which changes over time. Generally, the less time you have before you reach your financial goals, the lower your risk tolerance becomes because your portfolio doesn't have as much time to recover losses.
- + Talk with your financial professional if you experience life changes such as having children, caring for aging parents, inheriting a windfall or suffering a layoff. Any event that changes your income, debt, financial goals, portfolio funding levels or time horizon affects your risk tolerance.

Together, you and your financial professional can take deliberate, intentional steps to make sure your portfolio continues to suit your situation.

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