Tabar Gaul LLC

Gauging Your Risk Tolerance

What are the best saving and investment products for you? The answer depends on when you will need the money, your goals, and whether you will be able to sleep at night if you purchase a risky investment where you could lose your principal.

For example, if you are saving for retirement, and you have 30 years before you retire, you may want to consider riskier investment products, knowing that if you stick to only the "savings" products or to less risky investment products, your money will grow too slowly. In other words, given inflation and taxes, you may lose the purchasing power of your money. A frequent mistake people make is putting money they will not need for a very long time in investments that pay a low amount of interest.

On the other hand, if you are saving for a short-term goal, five years or less, you don't want to choose risky investments, because when it is time to sell, you may have to take a loss.

Risk tolerance is an investment term that refers to your ability to endure market volatility. All investments come with some level of risk, and if you're planning to invest your money, it is important to be aware of how much volatility you can endure. Your tolerance for risk affects your choice of investments and the overall makeup of your portfolio.

Consider the following factors when assessing your risk tolerance:

- **Personality:** Are you able to sleep at night while knowing that you've put a portion of your hard-earned dollars at risk in a particular investment? Remember, it might be easy to tolerate a high-risk investment while it is generating double-digit returns, but consider whether you'll feel the same way if the market takes a downward turn with your investment leading the way. It's best to invest at a level of volatility that you are comfortable with.
- **Time Horizon:** The sooner you may need to use your investment dollars, the lower your risk tolerance. For example, for money you plan to use to make a down payment on a house in 2 years, your risk tolerance is lower than if you're investing for retirement in 20 years. If you can keep your money invested for a long period of time, you may be able to ride out any downturns in the market (though time alone is no guarantee of higher returns).
- **Capacity for Risk:** How much can you afford to lose? Your capacity for risk depends on your financial position (i.e., your assets, income, and expenses). In general, the more resources or assets you have to fall back on, the higher your risk tolerance.

Investing in equities involves risks. The value of your shares will fluctuate, and you may lose principal. Past performance is not a guarantee of future results. Diversification does not ensure a profit or protect against a loss.

To help your Investment Advisor determine the proper mix of investments for you, please use the following categories to determine your ability to tolerate risk.

- **High Tolerance:** You can handle extreme volatility in your investments and the possibility of massive losses, and you're able to sleep at night when the market is in turmoil. You actually view downturns in the stock market as "buying opportunities" to buy low. Your target asset allocation tends considerably more towards equities with perhaps a ratio of 70% of equities to 30% bonds. You rebalance at every opportunity to take advantage of buying low and selling high.
- **Average Tolerance:** You can handle average-sized drops in price for extended periods, but the extreme stuff makes you anxious, jumpy, and unable to sleep at night. You generally take a long term view of the market by practicing "buy and hold" and resist selling after large drops. You establish a target allocation of 50/50 or 60/40 of equities-to-bonds. But you can be a little squeamish in rebalancing your portfolio which involves selling some of your winners and buying some laggards.
- **Low Tolerance:** Losses of 5 percent keep you awake at night. You generally invest in money markets, CD's, and bank accounts because you view the stock market as having too much risk. For your holdings in the stock market, you tend to "sell low" right after large drops and wait to reinvest ("buy high") until after the market has significantly recovered.

Finally, your Investment Advisor needs to account for many factors beyond risk tolerance when choosing the optimum portfolio for you. Here is a list of factors to consider.

- **Age** – Generally a younger investor has a longer term horizon and can recover from large market drops since he won't need the money until later. But most young people are inexperienced in investing so they have a natural tendency to be intolerant to risk.
- **Liquidity –** You may require drawing down on your holdings for education, a new car, a new home, medical conditions, or other things within a few years. In that case, your time horizon is rather short so your investments need to be liquid with little risk in losing value. Of course this comes at a tradeoff in earning a lower return.
- **Inflation** – Just because a person is entering retirement doesn't mean they should change all their investments to become conservative with lower risk. A retiree's nest egg may need to last 30 years or more and inflation will erode the buying power of portfolios which have minimal returns. An investor needs to carry some risk in order to maintain their lifestyle in the face of inflation.
- **Net Worth** – An investor with high net worth can typically assume higher risk with a portion of their portfolio without affecting their lifestyle much from market losses. But an investor of lower net worth, that is heavily dependent on their portfolio to make ends meet, assumes a greater risk of impacting their lifestyle during market downturns.
- **Beneficiaries** – Do you have beneficiaries that you would like to provide a large inheritance to or would you prefer to "spend your children's inheritance?"

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- **Life Insurance** – Do you currently have and plan to hold life insurance policies for the benefit of your beneficiaries?
- **Social Conscience** – Would you rather not invest in companies that are associated with tobacco, alcohol, or other products?
- **Pensions and/or Social Security** – Will you be receiving pension or social security income that will lessen your dependence on your portfolio income to cover your basic needs?
- **Retirement Date** – How soon do you plan on retiring?
- **Second Career or Other Income** – Do you plan to work during retirement to bring in some extra income?

The bottom line when it comes to risk and portfolio construction is that spreading your risk around, even if it is all high risk, decreases your overall exposure to any single investment or trade. With appropriate diversification, the probability of total loss is greatly reduced.

An Investment Advisor can help you to invest in an appropriate mix of equity and fixed income assets to maximize your return for a given level of assumed risk. This is known as maximizing your risk-adjusted return.

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