ARE YOUR INVESTMENTS AT RISK?

It can be hard to tell, as many investors don't really understand what risk is. Here's how to get a read on how much risk you're taking and whether you should dial it back—or dial it up

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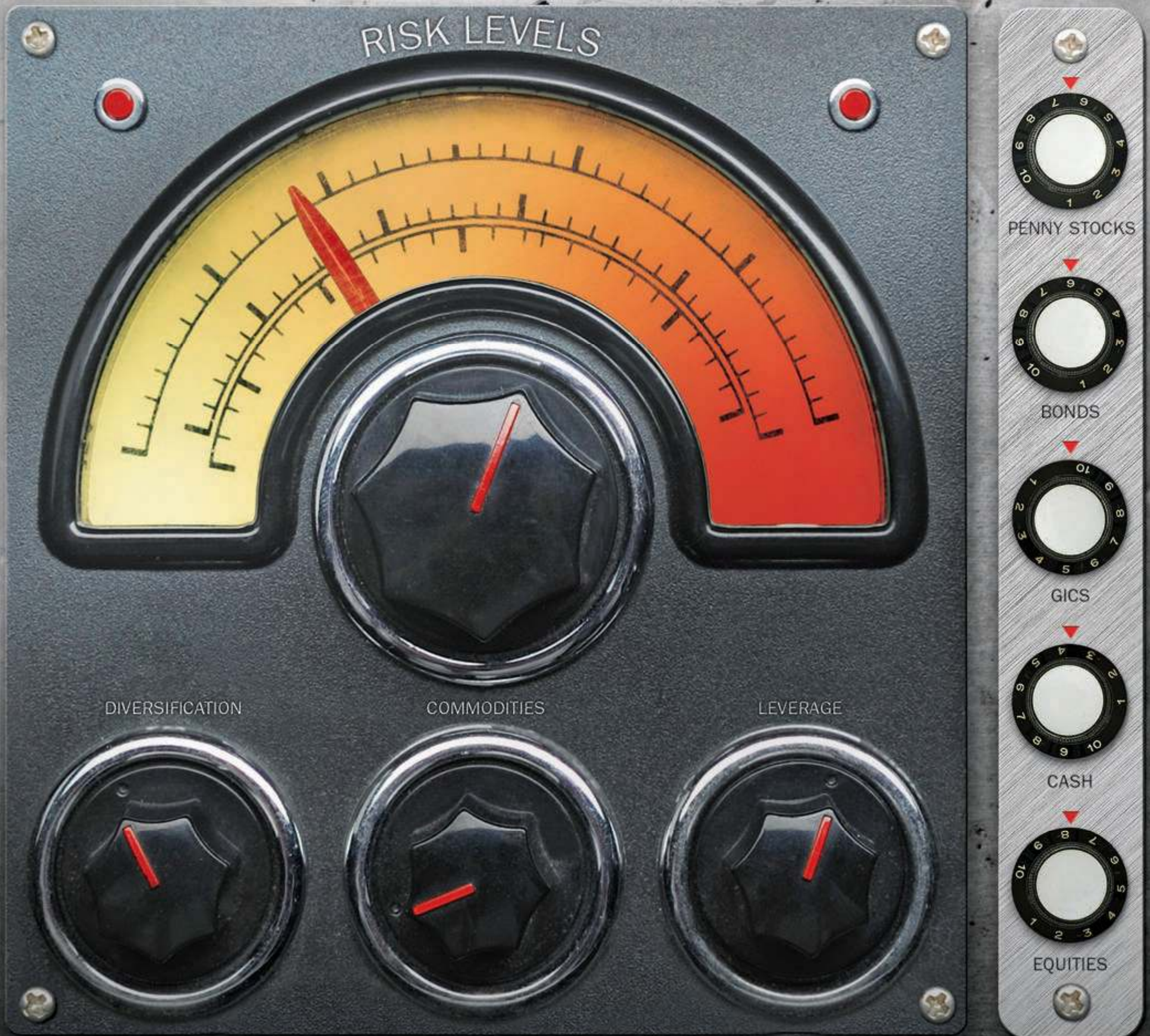
By Bryan Borzykowski



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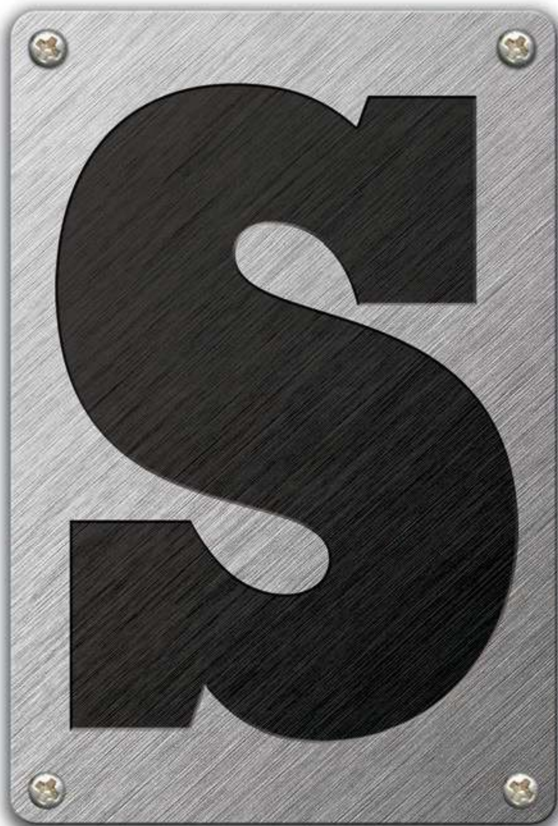


Stephen Weyman describes himself as a pretty terrible investor—and if you look at his track record, he's not off base. The Saint John–based software developer started buying and selling stocks in October 2008 as the market was falling. He was trading nearly every day, buying on the dips and selling those same stocks when they'd rise. While it seemed like a good idea at the time—"there were huge swings on a day-to-day basis," he says—after a few months he realized he hadn't made any money, yet he had used up a lot of his time.

Then in early 2011 Weyman put $4,000 in Yellow Media, the beleaguered phone directory company, without looking at its balance sheets or income statements: he was just chasing its 10%-plus yield. That was a big mistake—the stock plummeted, and he sold after it fell by 90%. "I didn't realize the company was at such a huge risk of a default," says Weyman. Today, the vast majority of his money is in Canadian equities, though he still has a whopping 16% in a single stock (Microsoft).

Weyman knows he has to change his strategy, and not just because blind stock picking is a bad idea. He's also having trouble understanding his comfort level with risk. He says he's an aggressive investor who is not afraid of losing money, but he admits his Yellow Media adventure made him feel "stupid," and that he's "not very comfortable" with his stock holdings today. So much so that he's considering giving up on managing his own money. "I've got two jobs and two kids and zero time," he says.

Weyman isn't the only one who struggles with risk in investing. A number of academic studies have also shown our risk tolerance is influenced by many factors, including the words used to describe an investment, our emotional state, prior market performance, and even our last meal. (A 2010 study found that people make riskier choices on an empty stomach.)

Advisers have a hard time understanding their clients' risk tolerance, too. Last year, Boston research firm Cerulli Associates surveyed more than 5,000 advisers who reported that 26% of their clients were aggressive investors, while only 14% were conservative. But when the firm surveyed the clients themselves, only 8% said they were aggressive, while 29% responded that they were conservative. That mismatch is likely to result in a lot of investors holding inappropriate portfolios.

The majority of investors fall somewhere between aggressive and conservative, says Paul Resnick, co-founder of FinaMetrica, a firm based in Sydney, Australia. He developed a test that takes into account both financial and psychological variables and more than 700,000 investors have taken it over the last 15 years. Nearly 40% received a score between 45 and 55, he says, which corresponds to a balanced portfolio of 40% to 60% equities, with the rest in fixed income. (If you go to moneysense.ca/risk, you can take the test yourself, free for a limited time.)

Getting your risk profile right takes work, but if you want a well-funded retirement and calm nerves it's crucial that you figure out just how much risk you can stomach—preferably before you're forced to take the ultimate test: watching the market crash while you're invested.

RISK REVEALED

Let's start with the idea that many people have no idea what risk really means. "How you define risk is tricky question," says Larry Swedroe, principal and director of research for Buckingham Asset Management in St. Louis and the author of 14 investment books. Risk can encompass everything from the way assets are weighted in a portfolio, to the amount you're willing to lose, to the probability you'll reach your retirement goals, he says.

It's also common for investors to think risk and uncertainty are the same thing, says Swedroe. But there's an important distinction. Uncertainty will always be there—it's impossible to know where the markets are headed—but if you're aware of the range of possibilities you'll worry less about that uncertainty. "Understanding risk means having a high degree of confidence in the range of outcomes," says Swedroe. "Insurance companies can't know exactly when you'll die, but they can be pretty darn sure about the odds based on actuarial science."

When investors and advisers measure risk they mostly look at volatility, or the price swings of a security or fund. But this is flawed, says Alan Fustey, managing partner and portfolio manager with Index Wealth Management in Winnipeg. "An investor perceives risk much differently." Most people don't care about a stock's volatility on the upside: they just want to know how much they might lose, he says. Market crashes like the one in 2008–09 are more severe and more frequent than traditional measures of volatility would predict.

Advisers need to explain these ideas when they help clients decide on the right asset mix. When Doug Elliott switched advisers in 2012, he and his planner had a two-hour conversation about his financial needs. The Mississauga, Ont., investor was asked what he planned to use his savings for, whether his portfolio could provide enough to live on today and in the future, how he handled the crash of 2008, and how much he thinks he'd be able to lose before abandoning his plan. Thanks to that conversation, Elliott, who has 70% of his money in stocks and 30% in bonds, realized that if he woke up tomorrow and

$500,000 was gone, he wouldn't panic. "It would be onward and upward and stay calm," says the 56-year-old.

IT'S NOT JUST VOLATILITY

The financial industry's focus on volatility has been a detriment to investors, says Eric Kirzner, the John H. Watson Chair in Value Investing at the Rotman School of Management in Toronto. There are many other important risks to consider, he says.

The first is the potential loss of capital: whatever the volatility of a stock, there is always the chance it could go to zero. Another is inflation risk: cash in a savings account generates a guaranteed return, but it's also almost certain to lose purchasing power over time. Many Canadians also fall prey to the risk of home-country bias, says Kirzner. According to a January 2013 Scotiabank survey, just 28% of investors say they own assets outside of Canada. Most people prefer investing in companies that seem familiar (our banks, cellphone providers and retail stores) and believe it's more risky to buy stocks from foreign countries. But concentrating all your assets in your home country, even if you're diversified among sectors and asset classes, is actually more risky than holding a global portfolio.

There's another idea that few investors understand when they consider volatility: they tend to look at assets in isolation, rather than considering them in context of the whole portfolio. When you combine risky assets together, the overall risk of the portfolio goes down—that's one of the main principles of diversification. Emerging markets stocks, for example, can be extremely volatile on their own, but adding them to a diversified portfolio can actually lower your risk. Yet investors can dwell on the individual moving parts. If emerging markets go down when stocks in other countries go up, they conclude they should have avoided them. But the fact that two asset classes tend to move in different directions is exactly why you should own both.

KEEP A COOL HEAD

While having a long-term diversified portfolio can mitigate some risks, none of it matters if you can't keep your emotions in check. Gary Ford has picked many winners and losers over his nearly three decades of investing, but the business owner in Burlington, Ont., still remembers the worst investment decision he ever made. In August 1987 he invested $150,000 in Manulife. By October, the market had collapsed by about 30%, much of it on Black Monday. "I felt ridiculously stupid," he says. "How could I have gotten it wrong by 60 days?"

Of course, anyone can get caught by an unexpected market crash, but it wasn't the massive loss that made Ford feel dumb: it was making such a concentrated bet. "I was living in Alberta, everyone was positive that the world was going to be marvelous, the market was frothy, so I said let's go," he says. "Then much of it disappeared in a day." Fortunately, he didn't panic and sell, and the market quickly recovered. But he learned an important lesson: investors need to keep their emotions in check in the good times as well as the bad times.

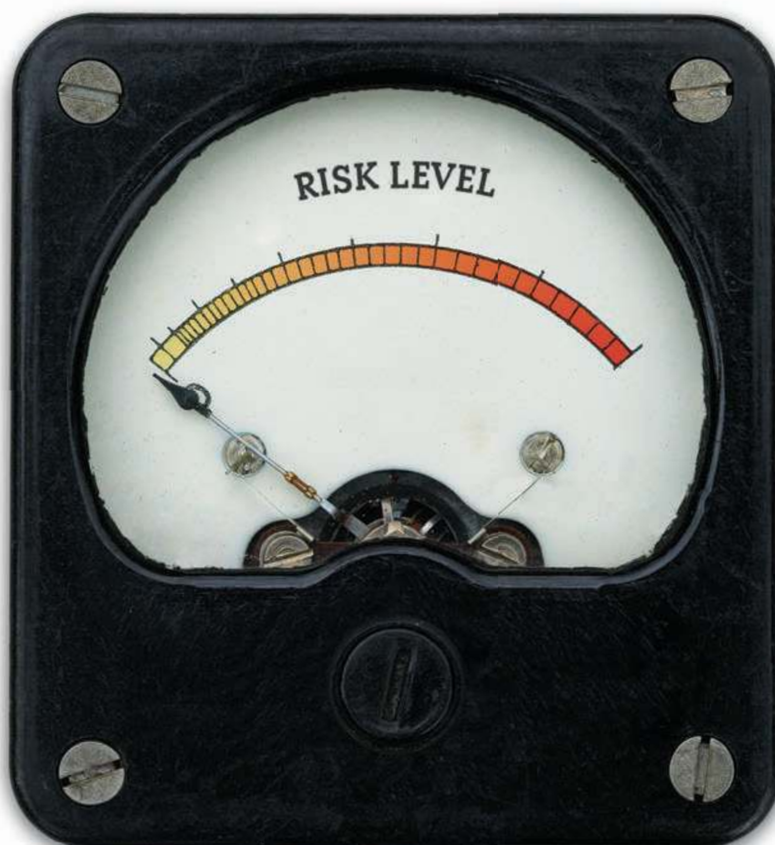
Here's another behavioural risk that is increasing in the age of social media. Studies have shown that the more people pay attention to the market's ups and downs the more risk-averse they become. While BNN, CNBC and other channels provide a steady stream of market updates, investors can see even more news—accurate and inaccurate—on their smartphones and tablets. "You start to see things you can't process," says Kirzner. "The more you see a company's price go up and down, or see some news about a business, the more likely you are to do something foolish."

DETERMINING YOUR RISK PROFILE

Determining your risk profile can take time: it involves thoughtful conversations with your adviser, well-designed surveys and questionnaires, and plenty of introspection. Larry Swedroe likes to frame the discussion in terms of three overarching questions: What's your *ability* to take risk? How much risk are you *willing* to take? And how much risk do you *need* to take?

Your ability to take risk depends on your time horizon and income stability. Doug Elliott started investing when he was in his 20s, so he had plenty of time to recover from losses, and his stable job and good salary would get him through a downturn. Now that he's getting older, he'll have less time to wait for the market to rebound. He still has a relatively high allocation to stocks, but he's thinking of buying more bonds.

Just as your ability to take risk is greater when you're young, it's also higher if your job is secure. Some jobs are like an annuity,



says Swedroe. A dentist or doctor will always be in demand and will always get paid, even when the economy is in turmoil. The same is true for tenured professors or many government employees. These fortunate workers can afford to take more risk with their investments. Construction and manufacturing jobs, however, are often unstable and economically sensitive, so people in those jobs should be more conservative with their portfolios. "Ask yourself, are you a stock or a bond?" says Swedroe.

Willingness to take risk speaks to the more traditional definition of the term: how much can you lose before you start to sweat? How much are you truly prepared to lose? Many investors are never properly asked about their willingness to take risk, says Alan Fustey. Questionnaires often talk about the wins, but rarely the losses. "It's all framed in a positive light," he says. "You either make money on income or on growth. There's nothing there about the losses."

Of course, declines happen, so you need to have that discussion. When you do talk about losses, consider them in dollar terms rather than percentages, says Fustey. Consider a young investor with a $50,000 portfolio. She might be willing to lose 20% because that works out to just $10,000, an amount that can be easily replaced with new contributions. But by the time that portfolio grows to $500,000, a 20% loss becomes $100,000, which may be a lot harder to stomach. That distinction may not show up in on a risk tolerance questionnaire. "Saying you're willing to lose 20% may not be an accurate statement as your portfolio grows," he says.

Your need to accept risk relates to the rate of return you require to meet your retirement goals. The Rotman School's Eric Kirzner says it's surprising how often people fail to see investing as a means to an end. If you don't have some sort of idea of where you want to end up, it will be far more difficult to make the right savings decisions. "The whole idea of investing is to set goals and then build a portfolio to meet those goals," he says.

Everybody's different, but Swedroe's rule of thumb is that a 65-year-old should have saved about 30 times their required annual income, so if you need $35,000 a year, you'll need a portfolio of just over $1 million. Once you have a goal and a savings plan in place, determine the rate of return you would need to meet that target. If you need a 6% return, then you'll need to accept some stock market risk. But if you need only 2%, you can dial down the risk level in your portfolio if you want to.

Doug Elliot says he's fortunate to have reached his own portfolio goal, so he doesn't need to take a lot of risk. "We've been fortunate that I've never had to panic," he says. However, he's not about to sink his savings into fixed income. His investing experience and comfort level with volatility will allow him to stay in equities in retirement.

The good news is your risk profile probably won't change much over time. Resnick asked 4,000 investors who took his test before the market crash of 2008 to take it again after. He found the average score dropped by just two points, from 54 to 52, while 80% of the test scores remained the same. For the people whose scores did change, Resnick says their perception of risk had changed, and not their risk tolerance. "People picked up more on the perception questions," he says. "They were more conscious of risk because of what was happening, but their willingness to stomach risk didn't change."

Fustey, who gives Resnick's 25-question test to his clients, agrees that people's tolerances rarely change. But their asset mix needs to be adjusted when their investment objectives evolve. If someone gets closer to retirement, they may need more dividend stocks or perhaps more fixed income to protect their capital.

PUT IT TO THE TEST

Risk surveys are useful, but you won't really know your tolerance for losses until a crash happens. Gary Ford admits he usually starts sweating after a 20% drop, but knows he's got his mix right, because he didn't sell during the downturns he's been through. He says he's never moved everything to cash, which is usually the worst thing an investor can do. If his investments drop and he gets out, it will be much harder to recover since he won't be invested when the market rebounds, he says.

After you've determined the optimal amount of risk, just leave your investments alone, says Kirzner. "Go to sleep for 40 years. Then you'll wake up and find you had a huge return because you hadn't done anything stupid."

For his part, Swedroe stresses it's also important to rebalance your portfolio by moving money from bonds to stocks, or vice-versa, to get back to your target asset mix. Swedroe admits this is difficult, but if you don't have the stomach to rebalance when markets move sharply, then your portfolio is probably too risky.

Stephen Weyman would like to create a portfolio that he can just leave be, but he knows he still has some work to do before he gets there. He took Resnick's test in May and learned that he was, in fact, a fairly aggressive investor. He got a score of 66—only 6% of people who have taken the test fall into that range. Still, Weyman thinks he's too heavily invested in stocks: the test says someone who gets a 66 should have between 65% and 84% in equities, not the nearly 100% he has today. Having a greater-than-average tolerance for investment risk also doesn't absolve him of his near total allocation to Canadian equities. He can still be aggressive and reduce risk by being more diversified. "I'm actually a little more cautious than I had thought," says Weyman. "I'll always have a higher allocation to equities, but I still have to make sure my savings don't all of a sudden go away." M

TEST YOUR OWN RISK TOLERANCE

Australian risk profiling firm FinaMetrica has developed one of the world's most popular and respected risk measurement systems, and for a limited time, they're letting *MoneySense* readers take it for free. Below are some sample questions from the survey. To take the full quiz, go to: **moneysense.ca/risk**

When you think of the word "risk" in a financial context, which of the following words comes to mind first?

1. Danger.
2. Uncertainty.
3. Opportunity.
4. Thrill.

If you had to choose between more job security with a small pay increase and less job security with a big pay increase, which would you pick?

1. Definitely more job security with a small pay increase.
2. Probably more job security with a small pay increase.
3. Not sure.
4. Probably less job security with a big pay increase.
5. Definitely less job security with a big pay increase.

Investments can go up or down in value and experts often say you should be prepared to weather a downturn. By how much could the total value of all your investments go down before you would begin to feel uncomfortable?

1. Any fall would make me feel uncomfortable.
2. 10%.
3. 20%.
4. 33%.
5. 50%.
6. More than 50%.