INVESTOR

Russell Investments

What is your risk tolerance?

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The concept of risk is unique to each person. An astronaut is likely to have a very different view of risk than an accountant.

But even among people with similar attitudes towards risk, there may be differences.

For example, Amy and Amos may both be interested in skydiving. They're equally willing to jump out of an airplane for an unforgettable thrill. But what if they were on the airplane and only Amy is given a parachute? They may both have the same risk tolerance, but they now have very different capacity to actually take the risk.

It's much the same when it comes to investing. Your attitude with respect to the potential of losing money is one factor. Your ability to absorb a financial loss is quite another.

What is your risk tolerance?

You have a unique risk profile: it depends on your stage in life, your background, your aspirations, lifestyle, and spending habits. Your risk profile may change over time as you move through different life stages and as your goals, circumstances and needs evolve.

The amount of risk you are willing to take – and have the ability to take – may differ at different points in your life. The younger you are, the higher your risk tolerance, whether we are talking jumping on a fast motorcycle or investing in the equity of a fast-growing company. This makes intuitive sense: Someone in their 20s or 30s still has plenty of time to accumulate savings or make up for any significant downturn in the markets. Someone who is on the verge of retirement or has already left the workforce and needs to live off the proceeds of their portfolio doesn't have the same investing time horizon.

Similarly, risk does not affect all investors in the same manner. A young couple beginning their careers and saving to buy a home would see that dream delayed if their savings were depleted in a significant market downturn. An older, more established couple who already own a home and have a substantial portfolio may be more able to withstand the impact of that downturn, since it would only hurt a small part of their overall net worth.

One of the key factors to successful investing is to know your tolerance for risk. Determining your risk tolerance is a matter of analyzing your personal financial situation and balancing it against your goals and objectives. Some investors are willing to accept lower levels of growth potential to minimize risk, while others are willing to take a much higher level of risk in return for more growth potential. Your financial advisor will guide you through a series of questions to assess your risk tolerance and determine your investor profile. Generally there are 3 types of investors: Conservative, Moderate and Aggressive.

Here are some concepts to help you understand how to measure your own risk tolerance and capacity:

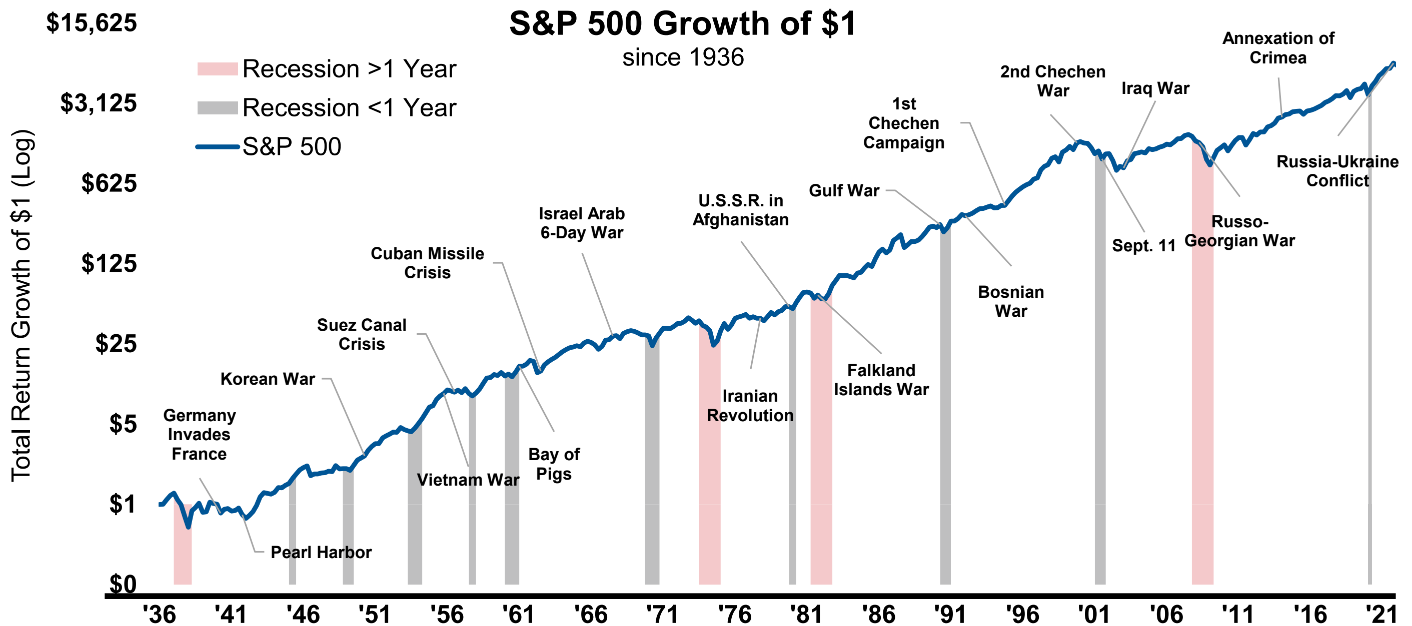
Time horizon

Young people with a longer time horizon are generally more willing to take on risks, as they'll have more time to make up for any potential downturns. Those who have left the workforce or are on the verge of doing so are generally less willing to take significant risks, since the retirement savings they have accumulated to date will be needed to sustain them for the rest of their life. They're likely to be more focused on preserving their capital.

However, people are living longer, and many investors will need their portfolios to continue growing even after moving to the decumulation stage. That means they will need the growth potential of stocks even beyond retirement. A general rule of thumb that is in common use in the investment industry is to ensure the percentage of a portfolio held in bonds equals the investor's age. That is, a 30-year-old would hold 30% in bonds and the rest in stocks, while a 60-year-old would hold 60% in bonds and the rest in stocks. However, the actual mix of bonds and stocks in anyone's portfolio would ultimately be determined by their risk tolerance.

The important thing to keep in mind, however, is that no matter your time horizon, the financial markets have traditionally risen over the longer-term even despite short-term disruptions. As the chart on the next page shows, the S&P 500 Index has pushed higher over the past 85+ years even through wars, pandemics and recessions.

Resilience of the U.S. stock market / History of moving through global conflicts



Source: St. Louis Federal Reserve & Morningstar Direct. S&P 500 Index as of 3/31/2022. Log: Lognormal scale.
Total Return: Includes dividend reinvestments.

Net worth

Your net worth is your assets minus your liabilities. You may feel more inclined to take greater risks if you have a stable income, little or no debt and if you have funds set aside that aren't needed for paying bills. If you're not struggling to cover all your monthly expenses, then you might not be as concerned about potentially losing money on an investment because you're not relying on those funds.

A high-net-worth individual likely has more money available to invest and can, therefore, be more risk-tolerant than someone with less capital. However, that person also has more to lose if the investment goes sour.

Sometimes, investors with lower net worth or limited capital can be attracted to riskier investments such as futures, bitcoin, or microcap stocks because of the lure of quick, easy, and potentially large profits. This is when working with an advisor can be particularly useful. They can help you determine what risks fit within your budget and can ensure that taking those risks have the likelihood of helping you reach your goals.

Investment Knowledge

Those who have deeper understanding of financial markets may have a better idea of the benefits and drawbacks of different asset classes or specific investments and can then take calculated and carefully considered risks, with an advisor's help. Those who don't have as strong a grasp of investment concepts may be even more dependent on an advisor's guidance and remaining in a balanced portfolio of stocks and bonds.

Goals

You may be more willing to take a risk if your spending goal is a boat or new car or vacation – all of which can be postponed without too much pain, if necessary – rather than an education or a house or a retirement portfolio. Conversely, more risk could be taken if you are using available capital, or disposable income to attempt to earn extra income.

The bottom line

Your attitude toward risk is ultimately determined by your individual personality. Do you make emotional decisions? Do you become distressed when markets fall? Are you more of a wait-and-see person? Do you check the value of your portfolio frequently or do you wait until quarter-end? While working with an advisor can help you avoid knee-jerk reactions to market volatility, your ability to stomach those losses is related to your personality more than anything else. That's why there's a long-held truism in investing: You can either sleep well or eat well.

Just because you can make riskier bets doesn't mean you should.

Spreading your risk across sectors, geographies, market size of companies and asset classes decreases your overall exposure to any single investment or trade. Diversification is the best way to counter investment risk. Because diversification can lower risk, you can select asset classes such as small-cap stocks, high-yield bonds, emerging markets bonds or international stocks that on their own could be volatile. As part of a broader mix within a portfolio, these exposures can help smooth out and potentially increase your return. And, as always, talk honestly with your advisor about your risk tolerance. They can help you design a strategy and asset mix that's right for you.

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Please remember that all investments carry some level of risk, including the potential loss of principal invested. They do not typically grow at an even rate of return and may experience negative growth.

As with any type of portfolio structuring, attempting to reduce risk and increase return could, at certain times, unintentionally reduce returns. Rebalancing your portfolio may create tax consequences on the taxable portion.

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