Investment Risk: Too Scared, or Not Scared Enough?

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Introduction
When dentists and other professionals refer to the risk involved in investing, most often they are talking about market risk – i.e., the risk of loss of principal, of actually losing money. And while market risk is important to the individual investor, there are a number of other significant risk types in the investment world that should not be overlooked by dentists.

Interest Rate Risk
“Interest rate risk” is the possibility that an investment’s value will change as a result of a change in interest rates. This applies most often to the value of bonds. It concerns many investors today because with interest rates so low, there is a genuine risk that bond values will decline as interest rates rise.

Credit Risk
“Credit risk” is the possibility that a country, company, or individual will default, rendering them unable to pay back their debt obligations.

Purchasing Power Risk, or Inflation
“Purchasing power risk”, AKA inflation, is an often overlooked but very important danger for investors. “Purchasing power risk” is an often overlooked but very important danger for investors. It’s a Fact
Ultimately, market risk is the type of risk that individuals and the media focus on — i.e., that the stock market or other investment markets will decline as a whole. The definition of a bear market is a drop of 20 percent or greater. From October 2007 to March 2009, the U.S. stock market as measured by the S&P 500 lost 56.6 percent.

What can the investor do to guard against this risk? To some degree, the answer is “nothing”. Any portion of a portfolio invested in the stock market will be subject to this volatility and the threat of significant loss. From a larger portfolio perspective, it is wise to diversify among asset classes that behave differently in different market conditions.

The risk in the market is not simply that it will decline periodically; that is a given. The most significant peril is that the investor will panic and sell at the bottom. Buying high and selling low may result in the permanent impairment of capital. Portfolio value declines, and by selling out at the bottom, it is difficult to make it back when the market recovers.

How can an investor avoid this potentially costly mistake? The answer is, by getting a handle on how much risk he or she should take with the portfolio. There are three factors to consider.

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consider: risk required, risk capacity, and risk tolerance.

Risk Required
“Risk required” is based on the return an investor needs his or her portfolio to earn in order to reach its goals. Investment analysis tools can be helpful to understand the risk required and potential outcomes. The investor may find certain options among various rates of return are more acceptable than others in attempting to reach his or her goals in the desired time frame. Working with a financial advisor to determine risk required is a good approach to help reach financial goals.

Risk Capacity
“Risk capacity” is the level of risk, as in loss, that a portfolio can withstand. If the investor’s financial plan is on track to meet his or her goals, but “just barely” and without any leeway, the portfolio cannot afford a large loss, as this will likely mean he or she will not reach projected goals. In this case, an investor’s capacity to take on risk, and the possibility of a significant portfolio drop, is low. The central question is, “If the portfolio underperforms its expected return, will I fall short of reaching my goals, or will I still be in a position to fund any shortfall?”

Risk Tolerance
“Risk tolerance” is a psychological measure of how much risk an investor prefers to take. Contrary to what many people believe, risk tolerance is a relatively enduring way that one individual differs from another, and it is stable for each individual. It is the individual’s perception of market risk that changes during a bear market, not that person’s tolerance for risk.

How to Proceed
For investors who are married and investing as a couple, each partner should take the risk profile separately, and then see how their answers align so that any mismatches can be addressed before proceeding to construct a portfolio.

First ask, what is the best way to accurately measure risk tolerance? An investor might start by using a validated risk-profiling tool. There are many brief risk-tolerance profiling tools out there — most investors have probably filled out these sorts of forms when opening an investment account — but most are not accurate in truly assessing tolerance for risk. In 2011, securities regulators in the United Kingdom found that only two of the 11 risk-profiling systems they reviewed were acceptable.

When crafting a financial plan and investment portfolio, it is important to pay attention to the many types of external risks such as purchasing power risk and market risk, as well as to an individual’s personal risk tolerance. When investors can appreciate the risks in their portfolios and their own personal risk tolerance, they will be able to craft portfolios that best match their goals.

Acknowledgment
I wish to thank FinaMetrica www.finametrica.com for sharing their work in the area of risk tolerance and risk profiling cited above.