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What You Should Know About Risk

By Daisy Maxey

Are you still game to take a bull market by the horns or ride out a long slump?

The volatile ups and downs of the market this past year have led many investors to rethink their appetite for risk. It's a crucial element in an overall investment plan, but many people likely don't know where they stand these days.

Some investors may be tempted to turn to an online calculator for help. While such tools can be useful to help pinpoint what's most important to you in retirement or how much of a loss you could stomach, their use as genuine assessors of your ability to handle investment risk is limited.

One problem is that an investor's responses to a risk calculator's queries may depend on recent experience, says Matthew Tuttle, a financial planner in Stamford, Conn. For example, asked how he or she would feel if the market declined by 20%, an investor would almost certainly have answered differently in December 1999, during the bull market, than he or she would have in December 2008.

"In 1999, you couldn't comprehend that, but in 2008, you're thinking, 'Oh, my God, I would never want that to happen again,'" says Mr. Tuttle. "You can get a very messed-up version of your risk tolerance, depending on the environment."

AGE MATTERS -- TO A POINT

So, then, how can investors better gauge their risk tolerance? To do so, they should take a number of factors into account, including age, income, savings, retirement plans, state of health and stomach for volatility.

Obviously, younger people can take on more risk as they have more time for compounding -- generating more earnings as existing earnings are reinvested and grow -- to do its magic, and more time to make up for any losses.

Investors who are age 30 or 35 should be celebrating market declines, says Bill Schultheis, a principal at Soundmark Wealth Management in Kirkland, Wash. They've got the chance to buy shares cheaply and a long investing horizon during which those shares could appreciate in value.

But age isn't the only factor. "It's not just whether the person can take the risk or not; their situation should determine the level of risk," says Tony Christensen, president of Louisville, Ky.-based Access Wealth Management.

If investors have a long time to invest and have built up decent savings, then they can afford to take a bit more risk. Even if they're conservative, they should still invest. On the other hand, if they're sending children to college next year, they should protect that money by investing conservatively, Mr. Christensen says.

Fran Kinniry, a principal at Vanguard Group's investment-strategy group, says he has worked with investors in their 80s and 90s who have 100% of their portfolios invested in stock. They tend to be sophisticated investors who are familiar with the equity markets, have enough money and are saving for second and third generations. But he also has seen 30-year-olds with 20% in stocks who won't budge.

"It's a balancing act between capturing the very large [premium stocks offer] and behavioral issues," Mr. Kinniry says. "Do I have so much in stock that it doesn't let me sleep at night?"

THINKING AHEAD

Your net worth also should be factored into the asset-allocation decision. An investor with $1 million sitting in a bank account who plans to invest another $100,000 can likely afford some roll-of-the-dice investments, depending on his or her lifestyle. But someone with just a 401(k) valued at $200,000 will want to take a more conservative route.

And investors with multiple goals may have multiple risk profiles. If you want to have enough for retirement, and also hope to one day be able to buy a boat or vacation home, for example, you could invest the money for retirement moderately to conservatively, but invest the boat money very aggressively, Mr. Tuttle says.

Since you can't predict your lifespan, it's best to take risk as though you'll live a long life. That way, you'll either end up with enough money to see you through retirement or leave your heirs a tidy sum.

And even if you plan to work after retirement, you should invest both conservatively and aggressively enough to ensure that your nest egg can carry you through without that post-retirement income. Plans to work can be stymied by a health issue or a layoff.

WHAT CAN YOU BEAR TO LOSE?

One tactic that may help when considering how much risk you can stand is to give some thought to how steady your hand would be if you were to suffer a big loss at this point in your life.

Investors love risk when the market's going up, but not when it's going down, says Mr. Schultheis, and a lot of them have not come to grips with the fact that the stock market is really a risky short-term investment. One of the first things he tells his clients is, "The market will drop at least 30% to 35% in your lifetime; you need to be prepared for that."

Mr. Kinniry shows investors different asset-allocation scenarios, then has them consider the toll the worst one-year or one-month period would take. He always puts losses in dollar terms. "We believe investors are somewhat immune to percentages," he says. "Thirty-two percent doesn't have the same impact for someone who has $100,000 as if you said that now they only have $68,000."

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