

Time for Investing's Four-Letter Word

What four-letter word should pop into mind when the stock market takes a harrowing nose dive?

No, not those. R-I-S-K.

Risk is the potential for realizing low returns or even losing money, possibly preventing you from meeting important objectives, like sending your kids to the college of their choice or having the retirement lifestyle you crave.

But many financial advisers and other experts say that when times are good, some investors don't take the idea of risk as seriously as they should, and overexpose themselves to stocks. So before the market goes down and stays down, be sure that you understand your tolerance for risk and that your portfolio is designed to match it.

Assessing your risk tolerance, however, can be tricky. You must consider not only how much risk you can *afford* to take but also how much risk you can *stand* to take.

Determining how much risk you can stand—your temperamental tolerance for risk—is more difficult. It isn't easy to quantify.

To that end, many financial advisers, brokerage firms and mutual-fund companies have created risk quizzes to help people determine whether they are conservative, moderate or aggressive investors. Some firms that offer such quizzes include Merrill Lynch, T. Rowe Price Associates Inc., Baltimore, Zurich Group Inc.'s Scudder Kemper Investments Inc., New York, and Vanguard Group in Malvern, Pa.

Typically, risk questionnaires include seven to 10 questions about a person's investing experience, financial security and tendency to make risky or conservative choices.

The benefit of the questionnaires is that they are an objective resource people can use to get at least a rough idea of their risk tolerance. "It's impossible for someone to assess their risk tolerance alone," says Mr. Bernstein. "I may say I don't like risk, yet will take more risk than the average person."

Many experts warn, however, that the questionnaires should be used simply as a first step to assessing risk tolerance. "They are not precise," says Ron Meier, a certified public accountant.

The second step, many experts agree, is to ask yourself some difficult questions, such as: How much you can stand to lose over the long term?

"Most people can stand to lose a heck of a lot temporarily," says Mr. Schatsky, a financial adviser in New York. The real acid test, he says, is how much of your portfolio's value you can stand to lose over months or years.

As it turns out, most people rank as middle-of-the-road risk-takers, say several advisers. "Only about 10% to 15% of my clients are aggressive," says Mr. Roge.

WHAT'S YOUR RISK TOLERANCE?

Circle the letter that corresponds to your answer

1. Just 60 days after you put money into an investment, its price falls 20%. Assuming none of the fundamentals have changed, what would you do?
 - a. Sell to avoid further worry and try something else
 - b. Do nothing and wait for the investment to come back
 - c. Buy more. It was a good investment before; now it's a cheap investment, too
 2. Now look at the previous question another way. Your investment fell 20%, but it's part of a portfolio being used to meet investment goals with three different time horizons.
 - a. Sell
 - b. Do nothing
 - c. Buy more
- 2A. What would you do if the goal were five years away?
- a. Sell
 - b. Do nothing
 - c. Buy more

identical utility, because the portfolios with higher expected return also have higher risk (standard deviation).

Estimating Risk Aversion

How can we estimate the levels of risk aversion of individual investors? A number of methods may be used. The questionnaire in the nearby box is of the simplest variety and, indeed, can distinguish only between high (conservative), medium (moderate), or low (aggressive) levels of the coefficient of risk aversion. More complex questionnaires, allowing subjects to pinpoint specific levels of risk aversion coefficients, ask would-be investors to choose from various sets of hypothetical lotteries.

Access to investment accounts of active investors would provide observations of how portfolio composition changes over time. Coupling this information with estimates of the risk-return combinations of these positions would in principle allow us to calculate investors' implied risk aversion coefficients.

Finally, researchers track behavior of groups of individuals to obtain average degrees of risk aversion. These studies range from observed purchase of insurance policies and durables warranties to labor supply and aggregate consumption behavior.

- 2B. What would you do if the goal were 15 years away?
- Sell
 - Do nothing
 - Buy more
- 2C. What would you do if the goal were 30 years away?
- Sell
 - Do nothing
 - Buy more
3. The price of your retirement investment jumps 25% a month after you buy it. Again, the fundamentals haven't changed. After you finish gloating, what do you do?
- Sell it and lock in your gains
 - Stay put and hope for more gain
 - Buy more; it could go higher
4. You're investing for retirement, which is 15 years away. Which would you rather do?
- Invest in a money-market fund or guaranteed investment contract, giving up the possibility of major gains, but virtually assuring the safety of your principal
 - Invest in a 50-50 mix of bond funds and stock funds, in hopes of getting some growth, but also giving yourself some protection in the form of steady income
 - Invest in aggressive growth mutual funds whose value will probably fluctuate significantly during the year, but have the potential for impressive gains over five or 10 years
5. You just won a big prize! But which one? It's up to you.
- \$2,000 in cash
 - A 50% chance to win \$5,000
 - A 20% chance to win \$15,000
6. A good investment opportunity just came along. But you have to borrow money to get in. Would you take out a loan?
- Definitely not
 - Perhaps
 - Yes
7. Your company is selling stock to its employees. In three years, management plans to take the company public. Until then, you won't be able to sell your shares and you will get no dividends. But your investment could multiply as much as 10 times when the company goes public. How much money would you invest?
- None
 - Two months' salary
 - Four months' salary

SCORING YOUR RISK TOLERANCE

To score the quiz, add up the number of answers you gave in each category a–c, then multiply as shown to find your score

- (a) answers _____ $\times$ 1 = _____ points
 (b) answers _____ $\times$ 2 = _____ points
 (c) answers _____ $\times$ 3 = _____ points

YOUR SCORE _____ points

If you scored . . . You may be a:

- | | |
|--------------|-----------------------|
| 9–14 points | Conservative investor |
| 5–21 points | Moderate investor |
| 22–27 points | Aggressive investor |

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6.2 Capital Allocation across Risky and Risk-Free Portfolios

History shows us that long-term bonds have been riskier investments than Treasury bills and that stocks have been riskier still. On the other hand, the riskier investments have offered higher average returns. Investors, of course, do not make all-or-nothing choices from these investment classes. They can and do construct their portfolios using securities from all asset classes. Some of the portfolio may be in risk-free Treasury bills, some in high-risk stocks.

The most straightforward way to control the risk of the portfolio is through the fraction of the portfolio invested in Treasury bills and other safe money market securities versus risky assets. A capital allocation decision implies an asset allocation choice among broad investment classes, rather than among the specific securities within each asset class. Most investment professionals consider asset allocation the most important part of portfolio