

Investment School: Your Risk Appetite

Your attitude to making money can say a lot about you. What would you do for \$10 million?

"One-quarter would abandon all their friends and church, or become a prostitute for a week, or change their race or sex. And 7 percent would even murder for that amount."*

But while many of us will do a lot for the promise of riches, it's surprising how little we do when it concerns our potential losses. And it's important to realise that risk refers to losses -- nobody cares about volatility if it's mainly in a positive direction. Yet the same survey noted that seventy-two percent of us don't even read the prospectus that comes with funds. Obviously most of us are not looking closely enough at our real risk appetite.

While some risk profilers ask you many questions on seemingly irrelevant topics like how much you intend to invest, we believe there are only two meaningful questions you need to consider:

Q1. How long are you investing for?

Q2. What's the most you could stomach losing in one year?

Investment timeframe

Time heals a broken heart, and just as it may work wonders for jilted lovers it can have an equally useful effect on investments. It means over long periods you can be comfortable with volatile assets (or portfolio) because the ups and downs will average out. But short-term investments mean you don't have the luxury of time to average out.

For example, if you invest for 1-2 years a downturn of 30% in the equity market could translate to an unrecoverable position. Moreover, not many of us can accurately forecast market directions over the short-term.

Generally those who are looking at a timeframe of 5-10 years or more should look at a volatile portfolio (e.g. high risk), even if their natural inclination is to low risk investments. Investors whose timeframe is under 5 years should think more carefully on what loss they can really bear. So in many situations your timeframe answers the question on how much volatility you should take.

Timeframe	Suggested Portfolio Risk
0-5 years	Dependent on risk appetite (Low to High)
5-10 years	Medium High or High
10 years or more	High

Largest comfortable loss

Most investors don't really know what their largest loss is likely to be in any one year. But with asset allocation tools it is possible to dimension the loss. Take a look at a few example portfolios, and their theoretical worst-case losses. The losses may be more than most investors really want to suffer.

Portfolio	Worst case 1 yr loss
50% international bond fund, 50% global blue chip fund	-14%
50% cash, 50% tech fund	-16%
33% cash, 33% tech fund, 33% emerging market fund	-23%
33% global blue chip fund, 33% tech fund, 33% emerging market fund	-27%
50% emerging market fund, 50% tech fund	-36%

Source: Simulations by dollarDEX. Worst case at 98% confidence interval

Without knowing the probable downside on their portfolios it's hard for investors to get a sense of the risk they are taking. This ignorance leads to big mismatches. For example, a portfolio with 50% in emerging market funds and 50% in tech funds would be *expected* to lose 36% in any one bad year. If you can't live with that kind of loss, the risk profile of your portfolio should be somewhat different.

* Are You Normal About Money?, Bernice Kanner