Risk: Are You Willing?

CFA Institute Contributor

By Stephen Horan, PhD, CFA, CIPM


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Meet Jim and Holly: This pair from a mid-Atlantic state has two children and lives in a nice house and each drives a newer-model, large car. They're certainly not "poor," but the couple is not exactly as rich as their lifestyle would suggest. That's because they spend a majority of their income and save only a bit for their children's education and their retirement. Still, the couple describe themselves as risk tolerant.

Now meet Anna: She's a widow. Her husband, who was a successful entrepreneur, left the woman a substantial nest egg. This woman from upstate New York had parents who lived through the Depression and has never thought much of buying "stuff" or spending for wants instead of needs. This woman behaves as if she has little tolerance for risk.

In Anna's case, as well as Jim and Holly's, we can observe that something is wrong. It's not the same thing in both cases: **Jim and Holly are more willing to take risk than able; Anna is more able to take risk than willing.**

These two examples from my work as an expert witness in securities litigation illustrate an important point about risk: We must learn to distinguish between our own willingness to take financial risk and our ability to do so.

Where it gets dangerous is the point at which investors believe they can take more risk than they actually can. Often, like Anna, they overemphasize a traumatic experience, forgetting to do proper risk analysis, or, like Jim and Holly, their optimism about the future causes them to take more risk than they should.

The Assessment

Two ways to understand your risk profile are questionnaires and personality typing tools; these instruments are often designed to help an investor understand his or her willingness to take risk.

Questionnaires often get a bad rap—and in some cases rightfully so—because they can be used in perfunctory, uncaring ways. They also can be valuable as part of a larger risk assessment. Often, they will probe personality traits by asking, "Do you like to play canasta? Do you like to drive race cars?" The problem is that race car drivers don't necessarily like investment risk.

I had a client who wouldn't be well served by a questionnaire. He founded and ran a manufacturing company and therefore considered himself risk tolerant. But as we dug down into his preferences, it turned out he was the kind of guy who liked the pencils lined up very neatly on his desk. He really liked control and was comfortable accepting business risks he felt he could control.

However, the traits that made him a successful entrepreneur didn't necessarily translate into comfort with investment risk. He realized that since he doesn't have the same control over his investments as he does over his business, he has less stomach for investment.

The second tool, personality typing, categorizes people into areas such as "cognitive decision maker" or "emotional decision maker." The cognitive folks tend to be more analytical. They are methodical, risk averse, and look before they leap. Emotional decision makers do the opposite.

The best approach is a combination of questionnaires, personality typing, self-observation and observation by your financial adviser. The most important thing to remember is that when it comes to risk, willingness and ability to bear it are not the same thing. In my next blog post, we will talk about assessing the ability to bear risk.

-With Rhea Wessel, a personal finance writer based in Frankfurt.

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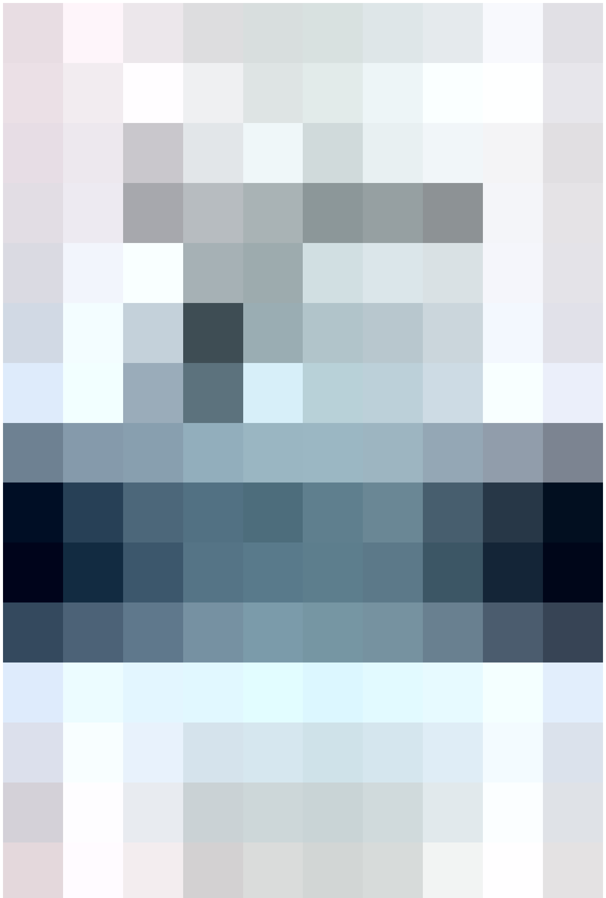
For more on understanding your own risk profile, see Chapter 1 of the Forbes CFA Institute Investment Course book.



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