

# How Does Your Risk Tolerance Affect Your Portfolio Risk?

Defining risk tolerance can be overwhelming, confusing, and an art rather than a science. Once a risk tolerance label is assigned the investor has to agree with the prescribed label for a defined period of time. Unfortunately, it takes the market to go haywire for that risk tolerance to be put to the test. This duality poses a question: "Is there a better way?" This article will discuss the purpose and side effects of risk questionnaires, a new company and program in the risk assessment market, and options for managing risk.

## Risk Tolerance Questionnaire

Anyone who has ever worked with a financial professional has probably completed some version of a risk tolerance questionnaire. Therefore, it is not far-fetched to say a risk tolerance questionnaire can be summed up with one word: ambiguous. For every questionnaire there is supposed to be a defined algorithm that accounts for every set of outcomes based on the answered questions. Unfortunately, half of the time the questions seem arbitrary. The other half of the time the answers seem more confusing than the questions. Consequently, how is an investor supposed to accept the risk tolerance label of a risk questionnaire if they are left scratching their heads?

For example, if asked "How much would the market have to decline before you would sell?" the average investor's answer might be "it depends". While the question is trying to gauge how much volatility or risk an investor can accept, it lacks a qualifier such as a specified time frame. An investor's answer will probably change as the time period increases.

While questions like these have the best of intentions, they are difficult to interpret and should be conducted with a qualified investment professional in order to address follow-up questions that will inevitably arise. It may even be necessary to conduct a risk tolerance questionnaire for different investment objectives or goals. This way an investor's concerns can be tailored and addressed with the respective resources in mind for that particular goal.

Once the questionnaire is complete, an algorithm attempts to accurately define an investor's risk aversion and correspondingly suggests an asset allocation that should match their volatility preferences. So, is the questionnaire correct? That question can be interpreted in different ways. Our belief centers around the results being rooted in math and sample size testing, which are also backed by other testing measures. My issue is not necessarily with the algorithm, but with the end result. For over a decade I have helped thousands of clients complete some version of a risk tolerance questionnaire. In each instance the end result was to tell the client they were defined by a label such as "Moderate Conservative, Moderate, or even Moderate Aggressive". The goal for assigning a risk profile in this fashion is not completely clear to me, and in fact seems rather arbitrary. If I was to guess, it would seem that this standardized risk profiling is designed to help investors understand their risk preference in an easily digestible way.

One problem with pigeonholing a person with a risk tolerance profile or label is that it might not be an accurate representation of their true comfort level. If an advisor asks an investor if a particular risk tolerance label "fits" them, it wouldn't be far-fetched to say they probably shrugged their shoulders and went with it. Why? I would liken it to taking a Rorschach test (the ink blot test), and having the tester ask the test taker how they did. Since the Rorschach test and risk tolerance questionnaires are both open to a

level of interpretation, the end result may be an accurate interpretation of someone's personal view, or it may be an incomplete assessment. In either case, it is the individual that needs to fully understand the result before accepting it, in order to be able to take the necessary steps to move forward.

## How To Manage Risk

[Portfolio risk](#) can never be eliminated, only managed. Even a U.S. Treasury (bill, note, or bond), that is often used as a proxy for a "risk free rate of return", is vulnerable to interest rate fluctuation and price volatility. Therefore, if portfolio risk cannot be eliminated, then what should you do to manage volatility within your portfolio? Well there is not a simple answer, but there are two fundamental principals that can be used when constructing a portfolio: asset allocation and diversification.

First brought into focus in the mid-1980's by [Brinson, Hood, and Beebower](#), asset allocation is believed to account for 94% of an average investment's performance over time. However, as more analysis was conducted by economists and researchers like Ibbotson and Kaplan, results highlighted how the mix of asset classes directly impacts performance. This link between performance and assets classes further supported the previous research done by Harry Markowitz in his 1952 paper on [Modern Portfolio Theory](#).

One of the central tenants of Modern Portfolio Theory (MPT) is diversification through non-correlated asset classes. Essentially, MPT states that there is an efficient way to manage risk and return using different asset classes. To do this an investor would assess the risk adjusted return of every asset class, and construct a portfolio of non-correlated asset classes that try to keep the investors risk tolerance

within a stated objective. If it sounds easy, it is not.

For years other economists and mathematicians have built off of this central tenant and have advanced how diversification is viewed. Today, depending on the goal of an investment, analysts attempt to diversify interest rate risk, currency risk, political risk, asset risk, and much more. Unfortunately, what this has done is support another heated debate, active vs passive management. In essence, passive management states that a well diversified index is a better investment strategy in the long run as the average investor will not beat the market. However, those in the active management camp believe the market can be inefficient at times which creates an opportunity for excess returns above index benchmark. I believe both arguments are supported with facts, and that there is a mix of the two concepts that can be employed to build an investment strategy that seeks to outperform broad indexes over the longer period of time. To this end, we believe anyone who has the skill, will, and time to devote to ongoing monitoring and management of their investment portfolio has the potential to observe expected outcomes.

## **Conclusion**

Risk questionnaires may be the starting point of a conversation with yourself, or with your advisor, but it is the understanding of the questions and the application of the results to your goals that impacts your portfolio risk. Asset allocation and diversification are two of the most important elements in portfolio construction and risk management, but without understanding your threshold for market volatility those elements become more theoretical than practical in application. For these reasons we believe investors should try to take as much ambiguity out of the risk assessment process, and one way may be through using Riskalyze's "Risk

Number” approach.

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