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Risk Tolerance and Your Investments: How Did You Do?

Did you breathe a sigh of relief when the Dow Jones Industrial average hit 10,000 last month? How were you feeling over the past two years as the market bounced up and down? But more important than how you felt is what you did, according to Karen Chan, Consumer & Family Economics Educator with University of Illinois Extension. "This was a real-world test of your risk tolerance. And now is a good time to review how you responded, and use that information to guide your asset allocation (and exposure to risk) going forward," she suggests. It's fine to ask yourself the questions frequently posed by risk tolerance tools, such as, *how would you feel if your portfolio lost 30% of its value*? Or, *what would you do if an investment lost 30% - sell all, do nothing, or buy more?* But now, rather than asking yourself hypothetical questions, you can evaluate your actual response to real-world events to gauge your true risk tolerance and whether the level of risk in your investments was appropriate.

How did you respond to the volatile stock market? Did you:

a) Neither buy nor sell any stock investments?
b) Continue with your intended investment strategy? For a working-aged person, that might mean continuing to invest in mutual funds each payday through your employer's 401(k) plan. For a retiree, you might have continued re-investing dividends or taking you usual distribution to support your living expenses.

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c) Sell part or all of your stock investments after the market dropped?

d) Delay taking distributions or planned sales of investments, to give them time to rebound?

e) Buy more investments, to take advantage of the drop in prices?

If you chose “c,” your investments may have been too risky for your personal risk tolerance. That could also be true if you did “a” because you were paralyzed by fear. Options b, d, or e represent a logical, rather than emotional, reaction and may indicate that your risk exposure was appropriate for your risk tolerance.

Having too much exposure to investments whose value fluctuates for your level of risk tolerance can lead to poor financial decisions. But you can also have too much risk tolerance – the emotional ability to handle these financial ups and downs – in comparison to your financial ability to handle that level of risk. Let’s look at an example. Suzie has few assets, but she has a high risk tolerance. She puts all of her savings into a stock mutual fund. But her daughter started college this fall, and part of that money must be used to pay tuition. Because values are still far below the prices at which she invested, Suzie must sell a greater part of her investments to cover her daughter’s tuition. Emotionally, Suzie could handle the ups and downs of the stock market over the past two years. But her financial situation (the fact that she needed to use the money in the next few years) should have dictated a more conservative investment portfolio.

Chan suggests, “Learning about the risks involved in investing can help you choose investments that are appropriate for you. And that knowledge can help you make wise decisions when faced with volatile markets such as those of the past two years.” To learn about different

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types of investments and the various kinds of risk they have, visit University of Illinois Extension's interactive website, **Plan Well, Retire Well: Your How to Guide** at www.RetireWell.uiuc.edu.

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