Can you emotionally handle a decline?

"Risk is like pain. Many believe they can handle it until they begin to hurt."
Unknown

Emotions can cause you to react in strange ways when times are tough. When you're stressed, you may sell when the markets are down and buy when they're high because you think you should DO SOMETHING. Establishing guidelines far in advance will help you stay disciplined when the markets are volatile.

Below is an exercise that measures your emotional tolerance for risk in relation to the amount of time available to reach your goal. The exercise will also help you determine how your assets could be allocated to meet your financial goals while keeping risk within a range acceptable to you. Answer the questions the best you can and score your answers to determine your risk/reward category.

Part One – (Emotional) Volatility/Risk and Reward Questions

Question 1
Which of the following statements are true about the way you wish to invest your money to achieve your goals?
(Importance of question: Do you need income or growth and how much risk will you take to get what you want?)

A. Safety of principal is the primary concern. The amount of growth and income of my investments are secondary objectives.
B. My investments should be relatively safe and emphasize current income.
C. My investments may be exposed to a *moderate* level of risk with a primary goal of generating current income. *Growth over time is a secondary objective.*
D. My investments may be exposed to a *moderate* level of risk with a primary goal of growth over time. *Current income is a secondary objective.*
E. My investments may be exposed to a *moderate to aggressive* level of risk and should emphasize growth over time, but should also *generate some current income.*
F. Investments may be exposed to a *moderate to aggressive* level of risk and should emphasize growth over time. The need to generate *current income is not important*.
G. Investments should grow substantially in value over the long-term and can be exposed to a high level of risk. The need to generate current income is not important.

Question 2

Below you will find seven various allocations of stocks, bonds and cash. Circle a portfolio (A to G) with the volatility range you are willing and able to accept. The ranges of returns are actual market returns. Remember, past performance does not guarantee your future results.

(Importance of question: This question will establish your maximum guideline for a decline. Once you circle a portfolio make a note of the worst 12 month decline.)

Portfolio	Highest 12 month return	Lowest 12 month return	Average Annual Return
A	21.1%	0.1%	4.9%
B	24.5%	-2.1%	6.5%
C	32.2%	-11.7%	7.9%
D	40.7%	-20.8%	9.1%
E	50.9%	-30.2%	10.2%
F	60.9%	-38.9%	11.1%
G	97.7%	-45.9%	11.8%

Question 3

In dollar terms: what is the maximum decline that you can emotionally handle over a 12-month period of time?

Note: Question 3 includes the same declines as question 2, but in dollar terms. It would be beneficial to assume a decline based on your personal circumstances. For example, if you have $50,000 to invest, and you choose Portfolio D, multiply $50,000 by 20.8% (the lowest 12-month return) and subtract this amount from $50,000—which would yield $39,600.

A. No decline
B. $10,000 declined to $9,790
C. $10,000 declined to $8,830
D. $10,000 declined to $7,925
E. $10,000 declined to $6,975
F. $10,000 declined to $6,112
G. $10,000 declined to $5,410

Question 4

Inflation can reduce the purchasing power of an investment portfolio. How do you feel about the impact of inflation on your investments?

(Importance of question: Do you want to beat inflation?)

A. It is not as important that my investments keep up with the pace of inflation. I am willing to allow the purchasing power to of my investment portfolio to be eroded in order to protect the principle of my investments.

B. It is important that the value of my investments keep up with inflation. I am willing to accept an occasional loss of principal in order to increase the potential of this occurring.
C. It is important that my investments grow faster than inflation. I am willing to accept some risk while trying to achieve this objective.
D. Over the long-term my assets should grow at a rate much faster than inflation. I am willing to accept a high level of risk while attempting to achieve this goal.

Part Two – Time Frame to Goal Questions

Question 1
When do you anticipate using **all** or a **substantial** portion of your investment or savings assets?
(e.g., college tuition in 5 years or a down payment on a house in 10 years) If you do not anticipate using **all** or a **substantial** portion of your investments please circle "E".
(Importance of question: If you anticipate using all or a substantial portion of your investment within a short period of time you should be more conservative.)

A. 3 years or less
B. 3 to 5 years
C. 5 to 7 years
D. 7 to 10 years
E. 10 years or more

Question 2
If you anticipate withdrawing a small portion annually from your investments, what is the time frame to your goal? (e.g., retirement - withdraw of $50,000 per year)
- If you are currently withdrawing a small portion annually from your investments please
circle "A".
- If you anticipate using all or a substantial portion of your investments answer question 2 the same as question 1.)
(Importance of question: As you get closer to your goal your asset allocation should be changing to a more conservative level)

A. 3 years or less
B. 3 to 5 years
C. 5 to 7 years
D. 7 to 10 years
E. 10 years or more

Score your points in the boxes below

Part One – (Emotional) **Risk versus Reward**

Questions / Answers = Points	**Points**
Question 1. A = 1 B = 2 C = 3 D = 4 E = 5 F = 6 G = 7	
Question 2. A = 1 B = 2 C = 3 D = 4 E = 5 F = 6 G = 7	
Question 3. A = 1 B = 2 C = 3 D = 4 E = 5 F = 6 G = 7	
Question 4. A = 1 B = 3 C = 5 D = 7	
(Emotional) Risk and Reward Total	

Part Two – Time Frame to Goal

Questions / Answers = Points	**Points**
Question 1. A = 1 B = 5 C = 8 D = 10 E = 14	
Question 2. A = 1 B = 5 C = 8 D = 10 E = 14	
Time Frame to Goal Total	

Transfer total points from Part One and Two to this box

	Points
Risk versus Reward	
Time Frame to Goal	
Total Score	
Risk/Reward Category	

Risk/Reward Category Chart

Risk/Reward Category	**Cat. 1**	**Cat. 2**	**Cat. 3**	**Cat. 4**	**Cat. 5**	**Cat. 6**	**Cat. 7**
Risk versus Reward	4 - 6	7 - 9	10 - 14	15 - 18	19 - 22	23 - 25	26 - 28
Time Frame to Goal	2 - 5	6 - 9	10 - 12	13 - 16	17 - 20	21 - 24	25 - 28
Total Score	6 - 11	12 - 18	19 - 26	27 - 34	35 - 42	43 - 49	50 - 56

← Lower Risk Lower Return ←→ Higher Risk Potential Higher Return Potential →

Here's how this exercise works: if your "risk versus reward" score is 17, you will be in Category 4 for "risk versus reward." If your "time frame to goal" score is 19, you will fall into Category 5 for "time frame to goal."

The sum of your two total scores, which is 36, places you in Category 5 overall, which means you can assume more than average risk to meet your goals in within your time frame.

"If investments are keeping you awake at night – sell down to the sleeping point"
Robert H. Thomas

It is vitally important that you be emotionally comfortable with your investment strategy. If you cannot sleep at night, then you must sell down to the "sleeping point." If you are not comfortable with your investment portfolio, not only will you be overly stressed and unhappy, but, as I mentioned previously, you are also likely to make bad investment decisions, especially in unfavorable market conditions.

Category One to Seven Considerations

Your personal asset allocation needs to reflect your unique situation. The allocations presented in below are a starting point—they give you an idea of how different asset classes should be mixed in a portfolio in relation to your tolerance for risk and your predetermined time frame.

All major investment and brokerage firms have their own asset allocation models and recommendations, some of which are modified according to market conditions and the general economic outlook. This is all well and good, and you can learn something by reviewing them. However, the news media often reports on these asset allocation recommendations as if they were scripture, which convinces many investors to slavishly follow the latest allocation fad. Don't go down this road. By understanding how asset allocation formulas are developed, you can find your own way and be more successful on *your* terms.

Exhibit 2.2

	Stocks	**Bonds**	**Cash or Equivalent**
Category 1	0%	90%	10%
Category 2	20%	70%	10%
Category 3	40%	50%	10%
Category 4	60%	35%	5%
Category 5	80%	15%	5%
Category 6	95%	0%	5%
Category 7	95%	0%	5%

Note: Category seven includes more aggressive stocks.

The asset allocation considerations listed above are the maximum risk recommended for each category. So, if you're confident that your goals are being met, you may not need to allocate your assets within a Category 5 if you scored a Category 5. A Category 4 may be more comfortable for you, especially if you scored in the lower range of Category 5. There's no need to live on the edge.

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