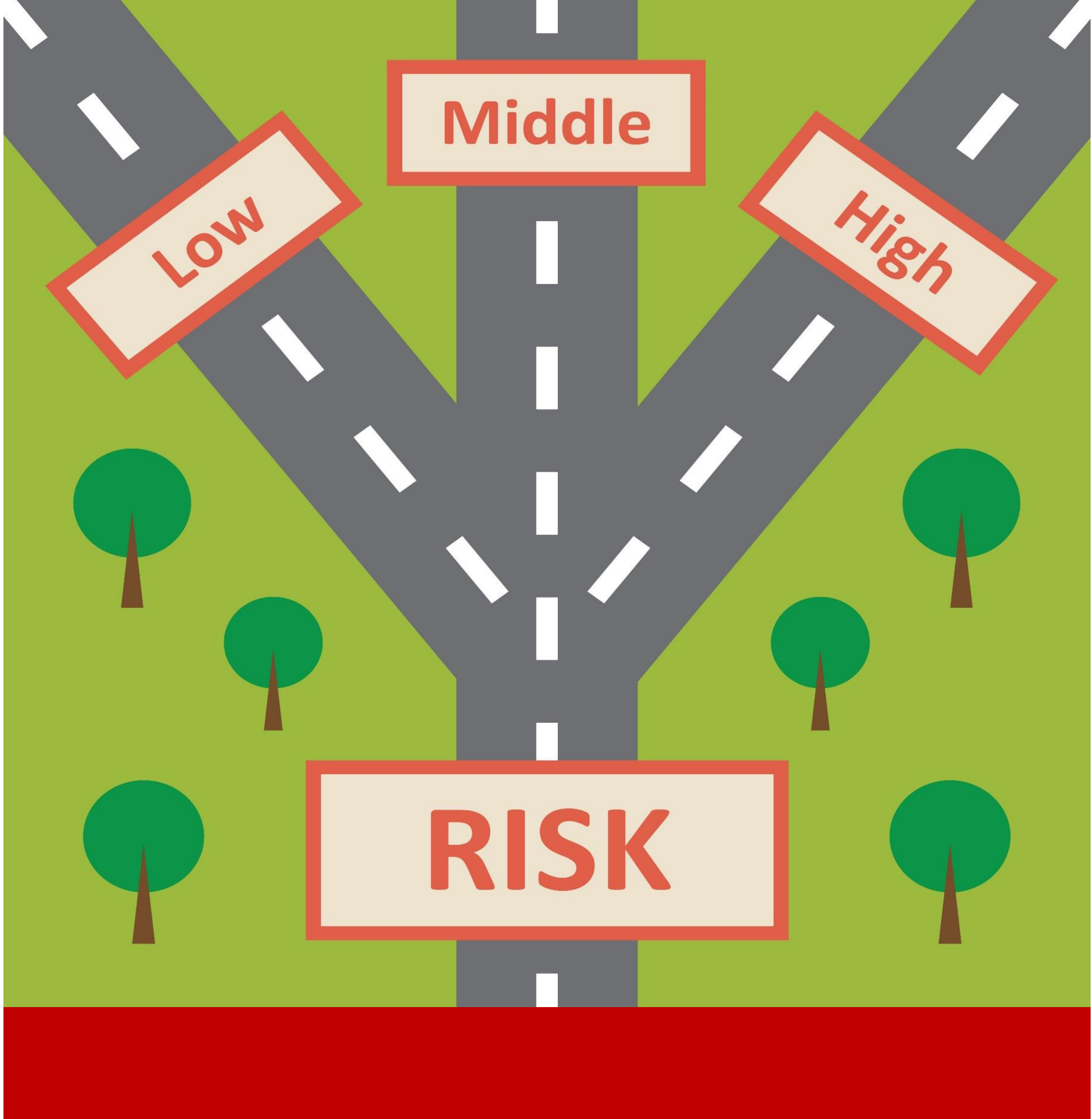

What's an Investor Personality?

Red Paper

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Introduction

> Whether an investor's goal is financial security in retirement or funding post-secondary education for their children, it's important to choose investments that match their investor personality.

Investors simply can't have it all (risk free). To get a reward, investors must be willing to accept some risk. That is the fundamental trade-off of investing; risk is involved with almost any investment. Investors must establish their investor personality to structure their investment strategy.

There is no singular investment strategy that is perfect for every investor. Investors have varying risk tolerances and different investment objectives. Many factors go into finding an "investor personality."

Financial advisors usually explore things like age, size of investment portfolio, expected retirement date, future earnings, and financial obligations to gauge an investor personality. These quantifiable aspects can tell us a lot about an investor's ability to take investment risk, but what about their willingness?

A good place to start is to determine how much time an investor has to reach their financial goals.

Time Horizon

An investor's time horizon is instrumental in determining how they should manage risk. The more time an investor has, the easier it will be for their portfolio to absorb risk. To balance both the income and growth levels of a portfolio an investor will need to allocate their investment assets according to both their level of acceptable risk as well as the amount of time they have available to achieve their goals. To help determine the time frame an investor needs for their investments, consider the following definitions:

- **Long-Term Investor** – if an investor's time horizon is five years and beyond, then they should consider themselves as a long-term investor.

- **Intermediate-Term Investor** – if an investor's time horizon is a minimum of two years and a maximum of five years, then they should consider themselves as an intermediate-term investor.

- **Short-Term Investor** – if an investor's time horizon is a period of one to two years, then they are a short-term investor.

Risk Tolerance

An investor's risk tolerance is the degree of variability in investment returns that they are willing to take. An investor should have a realistic understanding of their ability and willingness to stomach large swings in the value of their investments. For example, if an investor takes on too much risk, they might panic and sell at the wrong time. If an investor can understand their level for risk, then they won't feel panicked at every bump or blip on their investment portfolio's radar screen. To help determine a risk profile, consider the following definitions:

- **Aggressive Risk Taker** – An investor can withstand and recover from losses up to a maximum of 25% of their portfolio within a given year.
- **Moderate Risk Taker** – An investor can withstand and recover from losses up to a maximum of 15% of their portfolio within a given year.
- **Conservative Risk Taker** – An investor can withstand and recover from losses up to a maximum of 5% of their portfolio within a given year.

The Old Way of Determining Risk Tolerance

Financial advisors have been using the same method to determine an investor's risk tolerance for decades. They use a questionnaire and based on how an investor answers each question, it will determine their risk tolerance. Answers to the questionnaire help financial advisors determine how much investors should allocate to stocks, bonds, and cash (commonly referred to as asset allocation).

Taking a risk tolerance questionnaire during one five-minute period on one day in an investor's life isn't going to uncover their actual ability to handle a loss. An investor's risk tolerance isn't stable and most likely fluctuates based on how the market is behaving. For example, investors tend to be risk-seeking when the market is going up and risk-averse when there is a downturn in the market.

Risk tolerance questionnaires attempt to measure an investor's level of comfort with risk. Some of the questions are very direct in asking how much risk an investor is comfortable with or how they rank themselves along the spectrum of risk-takers. Other questions ask an investor how they would behave in certain scenarios. Most questionnaires only measure emotional ability and not financial capacity.

There are two components to an investor's risk personality. One is an investor's emotional ability to take risks, which is based on an investor's attitude toward financial risk and the degree of emotional pain experienced when facing or contemplating financial loss. The other is the person's actual capacity to take on financial risk which depends on such things as income, wealth, and investment horizon.

Research suggests that investors aren't very good at assessing their own risk tolerance. Trying to get a sense of how an investor would behave in the face of various adversities produces unreliable results. It is very hard for investors to gauge, with any accuracy, how they would react in the face of a 20% market decline until they experience one. Consequently, risk tolerance questionnaires measure risk tolerance based on hypothetical risk rather than actual risk. Saying an investor can tolerate a 20% loss, for instance, is quite different from actually losing 20% of their nest egg. The biggest problem with most risk tolerance questionnaires is that their results are highly correlated to past experiences. Think about it, it doesn't make sense to look backward for a forward-looking purpose.

The New Way of Determining Risk Tolerance

There is a shift going on from measuring the emotional and subjective response to a quantitative and objective approach that understands when an investor prefers risk and when they prefer certainty, based on the dollar amounts relevant to their financial capacity. We use an application called Riskalyze to help investors see just how much risk they are taking or need to take. It provides an investor with a clear picture of where they are in the risk spectrum and where they need to be. Simply put, it does a better job at capturing an investor's appetite and capacity for risk.

Managing risk in an investor's portfolio, as well as managing their expectations about risk, can be very challenging. When markets are up, investors want to know why they aren't doing better (which would require more risk than may be appropriate for their portfolio). Conversely, when markets are down, investors want to know why they're losing money (which would require less risk).

Our first step is to have an investor answer a 5-minute online questionnaire that covers topics such as portfolio size, top financial goals, and what they're willing to risk for potential gains. Then we'll calculate their customized risk number between 1 and 99. This number pinpoints their exact comfort zone for downside risk and potential upside gain. The lower their score, the less risk they're willing to accept. The higher their score, the more risk they can handle. Once we know their risk number, we then create an investment portfolio that aligns perfectly with their risk tolerance and goals.

In addition, we can also use the tool to analyze the risk tolerance of an investor's portfolio. Together, we can run stress tests to see how their investments would fare if there were an interest rate spike or an economic crisis. When it's all said and done, investors feel confident that their portfolio matches their personality and needs.

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What's your Risk Number?

We strongly feel that it's important to quantify the amount of risk investors are taking and compare it to what they are comfortable with over the next six months. Click on the icon below to get a free portfolio risk analysis.

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For more information, please contact Redhawk at either research@redhawkwa.com or (952) 835-4295.