What Investors Get Wrong About Risk

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One of the first steps to investing successfully is to determine your risk profile at the onset before building a portfolio. Investors often do this by answering a series of questionnaire that touches on their attitudes toward risk and also net assets.

The answers would then ultimately serve as a guide to asset allocation and set the risk-return parameters in a portfolio. Hence, it is a crucial step that investors need to get right at the beginning to avoid a risk mismatch in a portfolio.

But the concept of risk can be tricky terrain for investors to manoeuvre especially when psychological biases and market volatility comes into play.

Among the most common misconception that investors have is the level of risk that they are prepared to accept and actually able to take.

Understanding your Risk Profile

According to Investopedia, a risk profile is an evaluation of an individual's **willingness** and **ability** to take risks. There are two parts to the equation here, i.e. willingness and ability to take risks. Investors often get confused between the two.

Risk tolerance is the amount of risk/degree of volatility in one's portfolio that the investor is willing to accept or able to stomach mentally. This often varies with individuals and their own psychological makeup that forms their attitude towards risk and how they view the risk-return trade off. Adrenaline junkies and high-stake speculators comes to mind and are likely wired differently from the rest of us. As such one's risk tolerance is commonly inbuilt, though one can be coached to gradually learn to take risks.

Whereas, **risk capacity** measures the amount of risk/degree of volatility in a portfolio that the investor is actually able to take without unduly jeopardising one's financial security. Different factors like age, having a steady income and liquidity requirements are some of the determinants that affect the investor's ability to take risks.

To illustrate these two terms, consider a retiree in his 60s who no longer has a stable income and relies on his hard-earned savings to sustain his current lifestyle. Despite modest appearances, the retiree is a punter who enjoys taking risks and is able to tolerate large swings in his portfolio to get higher returns.

The retiree clearly has a high risk tolerance who is able to stomach volatility. However, the circumstances show that his risk capacity is actually limited given that he no longer draws a monthly salary as well as having a shorter investment horizon to recover from market drawdowns.

Conversely, a millennial who has just entered the workforce may be wary of taking risks and losing money in the market. However, he is gainfully employed with a stable monthly income and is also able to save a large portion of his salary after paying off rent.

Whilst, the millennial may have a low tolerance for risk since he is not familiar with the market and has never invested before, he actually has the capacity to take more risks due to a longer investment timeframe and also a stable income stream with few financial commitments.

The conundrum that investors face lies when one's risk tolerance and risk capacity differ from each other.

Taking too much risk than what one's risk capacity allows could compromise financial security and lead to undue risk in a portfolio which is more than what the investor's personal standing can handle.

On the flipside, taking too little risk when the investor's capacity actually allows for more aggressive exposure may lead to a shortfall in reaching their financial goals. This means that the portfolio would generate lower returns and the investor may have to settle for something for lower than originally intended or even delay their life goals/plans.

Reconciling with Risk

Whether one has an aggressive or conservative risk profile, all investors have an aversion to loss and hate losing money. However, risk should also be defined in terms of opportunity cost by not participating in upside gain due to not having sufficient exposure. Put simply, the risk of taking too little risk.

Understanding one's risk profile may require some form of discovery or trial-and-error. The best yardstick for investors to use is to ask themselves if they can sleep at night knowing how much wealth they have invested and confidence in their allocation.

Gradually though, investors can learn to manage risk through diversification across asset classes, sectors and regions as well as hedging (e.g. currencies) to have the best chances of success to reach their financial goals.

Sometimes, the biggest risk is not taking one.

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