Risk not changed just our perception **30/05/10**

There is a perception that financial markets have become riskier over the past two years. After the last week of yo-yo markets, it is easy to understand why people think this way.

People could also be forgiven for thinking that their own risk tolerance has changed since the global financial crisis.

But actually, market risk hasn't increased ... it's just our awareness of it that has.

And our risk tolerance hasn't changed either. We each have a risk tolerance that is hard wired into us and does not change with changing markets.

Financial risk tolerance is essentially a measure of how willing we are to take the risk of losing money for the chance of making money.

If you seek investment advice, one of the first things an advisor will want to know about you is your risk tolerance.

There are two components of risk tolerance – your risk capacity and your psychological tolerance.

Your risk capacity is the amount of money that you can afford to lose without significantly impacting your lifestyle or your ability to reach your goals.

Your psychological tolerance is about how much you can lose before you start suffering sleepless nights and getting anxious about your losses.

Interestingly, you can have a large risk capacity (i.e. be able to afford to lose a lot) but have a low tolerance for losses. Or you can have a small risk capacity but be able to easily accept the idea of losing money on the way to making money.

The old-fashioned way of determining your risk tolerance involved answering a series of questions like, how many months living expenses could you afford to pay if you lost your job? How would you feel if there was a 10% drop or a 20% drop in the value of your investments? And could you tolerate one year of negative returns out of five?

You would generally have been shown the long-term returns from different asset classes and on the basis of how you felt about risk, you could have an investment portfolio constructed for you.

The problem now is that those long-term returns don't account for extreme markets such as those we have experienced in the last two years. It's all very well knowing that the New Zealand share market has produced an average return of 14%pa over twenty years, but that knowledge doesn't prepare us for when share markets fall ten percent in one month!

An Australian research firm analysed the risk tolerances of 300,000 investors late last year and found they had not significantly moved post-GFC from their previous levels. But what had changed was their perception of risk.

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The global financial crisis has reminded everyone that risk is always there and that we should make sure that our investment portfolios are consistent with our risk tolerance.

If you were able to tolerate share market risk before the downturn, you will still be able to now. You might just have a slightly lower risk capacity, so might prefer to invest a little less.

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