KELLY FINANCIAL SERVICES LLC

What's Your Risk Number? Why It's Important To Know

By James P. Freeman

"There are risks and costs to action. But they are far less than the long range risks of comfortable inaction."

– John F. Kennedy (35th President of the United States)

In life, you make choices about risk, including how much risk to take doing everyday things -- speeding down a highway because you are running late, climbing a ladder to clear out gutters, binging on junk food because it feels good. Emotions largely govern whether you act upon or avoid altogether the risk at hand. That decision is a qualitative one but there is a quantitative aspect, too, as you process the risk/reward quotient. Some risks are bigger than others. But there is a tangible result by acting or not. The same may be said about risk in retirement planning. You can and should discern, understand, and manage the risks in your portfolio. And you might profit from risk.

The late co-founder of Kelly Financial Services, William A. Kelly, understood the role that risk plays in retirement planning and portfolio construction. In his book, *Senior Safe Money Strategies, Retirement Survival for Seniors*, he identified 12 threats to individuals and their portfolios. Five concerned risk: market risk, interest rate risk, concentration risk, currency risk, and political risk. And risk tolerance plays a central role in any larger discussion about risk in retirement planning, too.

Risk tolerance certainly appears to be on the minds of a lot of people these days. In late 2020, Kelly Financial Services surveyed all its clients. The survey was not scientific but the feedback from investors was telling. In response to the question "Which of the Following Would You Like to Know More About?," the top three responses were, in order: 1) Tax-Efficient Strategies; 2) Retirement-Income Analysis; 3) Risk Tolerance.

What exactly is risk tolerance?

Risk tolerance is your threshold of pain. More practically, risk tolerance is the ability to withstand losses when your investments perform poorly. Barbara Marquand in nerdwallet.com puts it this way: “How much of a drop in the market can you stomach?” Everyone’s risk tolerance is different but it is important to remember that your retirement goals are interrelated with your risk tolerance. This is part of the process. Once certain goals are established, plans are created, and then a portfolio is crafted with the intention to achieve stated goals. A robust review process is employed to monitor, and, likely, make adjustments, to ensure that desired goals are reached.

We have all heard of the risk/reward equation. Higher risk may be rewarded by higher returns; conversely, high risk may be punished by low to non-existent returns. But risk can be measured and calibrated to help achieve goals.

Marquand understands that there are some determining factors in risk tolerance. They include goals, timeline (time horizon), age and life stage, portfolio size, and personal comfort level, among others. It is important to take risk seriously. An imbalance in your risk tolerance and the risk identified in your portfolio can affect your goals. But that imbalance can also be corrected. A financial advisor can help you along the path -- from discovery to destination.

Emotionally driven investment decisions and risk tolerance figure prominently in behavioral finance, an area of study focused on how psychological influences can affect market outcomes. The field has gained increasing attention in academia over the past 20 years or so. And a recent study provides some fascinating insights.

The study, “The Importance of Staying Positive: The Impact of Emotions on Attitude to Risk,” published on ssrn.com (Social Science Research Network) in April 2020, examined the impact of emotions on investing in general and financial risk-taking in particular. Larry Swedroe, chief research officer for Buckingham Strategic Wealth and Buckingham Strategic Partners in the United Kingdom, wrote about the study and the impact of emotions on risk tolerance for advisorperspectives.com. He concluded that, “It’s also important for investors and investment advisors alike to be aware that risk tolerance varies not just over time but also with changing mood.” And he noted that risk tolerance rises with income, self-assessed investment experience, objectively assessed financial knowledge, and educational level.

Swedroe also believes that advisors need to be aware of their clients’ emotional state when discussing risk tolerance and asset-allocation decisions so that they can tailor what and how advice is provided.

The 2020 study also found stark differences between men and women in investment attitudes. For instance, women are less risk tolerant than men at all ages. They are also more fearful and nervous about investing than men. And women tend to state that they have lower levels of investment experience than men: Just over 50 percent of women put themselves in the lowest experience category, versus 21 percent of men.

Despite the impacts of COVID-19 on the financial markets in 2020 (and more so, the larger economy -- a pandemic-induced recession), markets have rallied. The great bull run that began in 2009 was only briefly interrupted in the spring of 2020, and largely continued unabated. In fact, the bull sentiment has roared ahead, with the markets frequently setting new record highs. As the economy continues to recover from the effects of pandemic-induced shutdowns, markets seem poised to continue their upward trends.

Of course, negotiating risk in bull markets brings its own set of challenges.

T. Eric Reich addressed risk tolerance in the bull market era in kiplinger.com in late 2019, before anyone had heard of COVID. He asked, “Am I invested where I'm supposed to be?” The question -- and answer -- is important because it can help determine the impact on your portfolio when the market falls again. Reich believes that investors should look closely at their risk tolerance, considering time horizon, having various other investments and income sources, having investments that are well spread out, ability to sleep at night, and other factors, such as emergency funds and inheritances.

Reich, a Certified Financial Planner ™, offers the following advice: “It all comes down to helping your adviser truly get to know you and what's important to you. It's not always easy to figure out at first when investing, but in time, it will become more apparent when you go through different market cycles together.”

Then there is the question of risk itself, and the myths of investing. Contributing to forbes.com in 2018, Jeff Rose wrote about how much of the risks of investing are “really lies.” He offers this assessment about risk:

> *“We often hear a lot about the potential risks of investing. But less common are discussions of the consequences of not investing. There are plenty of those. When you're aware of what they are, you begin to realize the risks of investing aren't that big by comparison.”*

Rose says that if you don’t invest, “you’re not preparing for retirement.” And when you reach retirement age, you may have to depend on others to take care of you. He warns that if you don’t invest, you’ll be no better off in 10, 20 or 30 years than you are right now.

Greg Workman is an investment advisor at Kelly Financial Services. He is also an Accredited Investment Fiduciary ® as well as a Long Term Care Professional. He recently appeared on Senior Safe Money Strategies radio program and the Kelly Advisor podcast to discuss risk. His perspectives are compelling and clear. He uses a striking example that is as much literal as metaphoric: golf.

As Greg reminds us: “Often in golf tournaments the pin is purposely put in place to tempt you to take a risk that could either reward you richly or ruin your chances for a win.” And he cautions, “It is easy to think we can go for it, but most golfers, even the most skilled, end up in some sort of trouble when they do.”

Greg recognizes that the risk you *want* and the risk you *need* and the risk you *have* in your portfolio are interconnected. The software tools that Kelly Financial uses can pinpoint risk in a portfolio. As Greg says, “Based on actual historical data from the markets, we can establish a 95 percent probability range for your portfolio’s performance. We empower clients to become fearless investors!” (However, Kelly Financial cannot predict where a portfolio might end up inside the range, and there is a 5 percent probability that it will end up outside the range.)

All these variables impact your retirement goals, as you consider that aligning your tolerance for risk with the risk actually in your portfolio is important. The advisors at Kelly Financial have seen firsthand when there is an imbalance between one’s risk tolerance and actual risk in a portfolio. Some clients may say they have low risk tolerance even as an analysis of their portfolios may in fact reveal the risks in the portfolio to be high. And, from another perspective, one may have ambitious retirement goals but the portfolio may be so conservative that it will never generate the income to achieve those goals.

The good news is that this disconnect can be corrected from a quantitative and qualitative standpoint. Regarding the quantitative, software tools can help place an objective, numeric value on the risk in a portfolio, on a relatable and understandable scale (from 1-99, for instance; lower number, lower risk; higher number, higher risk). From a qualitative standpoint, this exercise helps reduce emotionally driven investing.

Left to their own devices, individual investors applying a do-it-yourself (DIY) mentality to investing are prone to let emotions get the best of them. There is plenty of evidence that suggests emotionally driven investment decisions result in poor individual performance, relative to overall market performance (buying high, selling low). Performance by itself is not the issue; but performance that affects your goals is. A disciplined approach helps close the gap by reducing emotionally based qualitative impulses and increasing quantitative truths (reason) so that performance can be improved, which, in turn, will likely help you achieve your goals.

The results of research done by Dalbar Inc., a company that has studied investor behavior for over 25 years, consistently show that the average DIY investor earns below-average returns. Why? “Investor behavior,” writes Dana Anspach in The Balance, “is illogical and often based on emotion. This does not lead to wise long-term investing decisions.” A tendency to overreact to events and other short-term circumstances plays a role. This emotional reaction causes illogical investment decisions. Anspach underscores this important point. “It’s been academically proven that a disciplined approach to investing delivers higher market returns.”

Kelly Financial Services uses a powerful software tool to assess risk in clients’ portfolios. Applying a metric for a risk profile is an important aspect of retirement planning. A risk profile is also related to goal setting. Once you identify and set your short-term, medium-term, and long-term goals, you can build a portfolio with risk-adjusted investments to help you achieve your goals. The software is not perfect but it offers high probability for attaining those goals. Investors cannot eliminate all investment risk, and there is still a 5 percent probability that the portfolio does not perform as expected. Indeed, it is important to remember that investing does come with risk. Consultation with a trusted professional financial advisor can help you with this process. The key takeaway is that risk can be measured and understood -- by those approaching retirement and even novice investors who are not financial professionals.

Kelly Financial lets people begin the process online. You may go to kellyfinancial.org and click on the top of the landing page for the free risk analysis tool.

Kelly also recently published a consumer guide titled "Navigating Market Volatility: It's All About Perspective." We understand that market volatility makes investors understandably nervous. However, we know that markets go both up and down and reaping the rewards of investing comes with risk. Of course, that is easy to accept in times of growth, but it is much harder when market volatility arrives and we feel pressed to take action based on emotions, not logic.

Despite the recent record bull market (March 2009 to March 2020; 11 years or nearly 132 months), we have had tremendous market turbulence. Remember the dot.com bust in 2000? Or the Great Recession in 2008-2009? Then COVID-19 hit in 2020. We have been told that these were once-in-a-lifetime events. Funny, we have experienced once-in-a-lifetime events every 10 years for the last couple of decades. What is looming next?

Writing for *The Wall Street Journal* in September of 2017, Meir Statman makes a compelling case about the emotions surrounding one's risk tolerance. He says that advisors "take all sorts of different concepts -- such as regret, fear and overconfidence -- and they lump them all together under this vague concept called risk."

A better approach would be to look at these concepts individually and examine each on its own merits. Indeed, calling them risk "ends up distorting more than clarifying, and leaves investors with portfolios that may be disturbingly inappropriate for their goals." Furthermore, risk should be understood in the context of aspirations and goals. Risk is also the risk of also failing to meet our goals. Questions of goal-setting and maintaining a standard of living come into play. There is another way of thinking about risk, as Statman points out. An investor may claim to have a low tolerance for risk but his portfolio may be high risk "when assessed by the likely large shortfalls from even modest aspirations for adequate retirement savings."

In the final analysis, risk is everywhere and a constant. But risk can also be harnessed and used to your advantage with tools and discipline.

James P. Freeman is the director of marketing at Kelly Financial Services LLC, based in in Greater Boston. He has 25 years' experience in financial services. This content is for informational purposes only and does not constitute an offer to sell or a solicitation of an offer to purchase any interest in any investment vehicles managed by Kelly Financial Services, LLC, its subsidiaries and affiliates. Kelly Financial Services, LLC does not accept any responsibility or liability arising from the use of this communication. References made herein to any software applications are provided as informational and educational tools only, and no guarantees of performance are made. No representation is being made that the information presented is accurate, current or complete, and such information is at all times subject to change without notice. The opinions expressed in this content and or any attachments are those of the author and not necessarily those of Kelly Financial Services, LLC. Kelly Financial Services, LLC does not provide legal, accounting or tax advice and each person should seek independent legal, accounting and tax advice regarding the matters discussed in this article.