

Was it "Risk" or "Pain" That I'm Supposed to Tolerate?

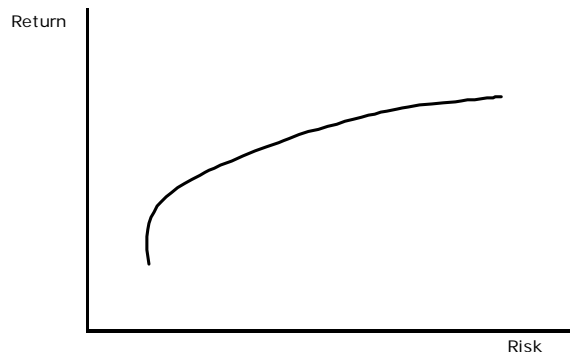
Standard operating procedure at nearly every brokerage firm, insurance company or other financial advisory operation is to talk with new prospective investors and learn some things about them. There are securities laws and regulations that require the advisor or broker to "know the client." Plus, it just makes good sense. You have probably been through such conversations yourself.

This process of learning about the client is, happily, widespread and almost universally practiced. At least it is in the mainstream and responsible companies.

The objective of this learning process is to figure out the investor's "risk tolerance." Risk tolerance is a cornerstone of determining what sorts of investments are right for each investor. Different firms will determine your risk tolerance in different ways. Most ask you to fill out some sort of form where you answer multiple-choice questions about your age and your goals and how much money you would be willing to lose in any given year.

Somewhere toward the end of the meeting with the advisor, he or she tells you that you have a risk tolerance of "X". You are conservative or aggressive or somewhere in between. The idea is that the mutual fund or portfolio that is recommended will match up with your risk tolerance. You might have seen the standard graph that depicts a line curving up and to the right:

As we move to the right and into more risk, the graph shows that the portfolio will produce more return. This usually means owning ever-larger servings of stocks.



The advisor runs his or her finger out along the bottom of the chart to the point of your personal risk tolerance, and then up the chart to find out how much of your

investments should be in stocks versus bonds. The line on the chart is computed using databases of historical gains and losses on various portfolio blends. This can all be made to seem quite scientific. The pretty graph has a title on it that says, "Modern Portfolio Theory," and the advisor proudly informs you that this little chart is based on Nobel Prize-winning work.

Frankly, I find this entire process puzzling and even somewhat bizarre.

Another term for *risk tolerance* is *pain tolerance*. After all, we are talking about how much pain you are willing to suffer in the pursuit of investment riches.

Now, think about that fancy chart for a minute. If I run my finger along the bottom edge, all the way out to the point of your maximum pain tolerance, what does that say about the portfolio I just chose for you? What it says is that, according to historical patterns, we can confidently expect that portfolio to bring upon you *exactly the maximum amount of pain you can possibly tolerate*. Now, is that what you really had in mind? I have another way of thinking about it.

Just because I would tolerate a poke in the eye doesn't mean that I actually want one!

I ask investors all the time how they feel about risk. They always say the same thing: "I don't like risk. I'd rather not have any if I don't have to." Likewise, that's how we all feel about pain. I don't like pain. I'd rather not have any if I don't have to.

In my view, that is a more sensible approach to risk. Our industry assumes that risk is a static thing, and that investors will just accept a certain level of pain over and over again. Money managers focus on maximizing returns while holding risk at the highest tolerable level.

In contrast, individual investors want the *risk itself* to be managed. Managing risk means to hold it down to the lowest level possible, while still achieving the client's financial objectives. If that risk level is lower than the investor would be willing to tolerate, then the advisor has done a good job.

Yes, seeking higher returns can often entail more risk. But, sometimes the higher returns are not high enough or are too uncertain, and risk should be taken out of the portfolio. I know of investors who are quite willing to take big risks with their money, but would be foolish to do so. Why? Because they don't need to. Their goals are modest, they'll never run out of money and a low-risk portfolio will give them all the growth they will ever need. Why spend your retirement running back and forth across freeway lanes when you can instead stroll on an empty beach?

The next time somebody asks you about your risk tolerance, I want you to think about pain tolerance. Then think: How much pain do you really want to experience?