How Does Exchange Determine Risk Tolerance?

By: Exchange Capital Management

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One of the most crucial aspects of a successful long-term financial plan is determining an appropriate level of risk. Unfortunately, this is also one of the most difficult components to nail down due to the emotional conflicts we have as humans.

At Exchange, we break down risk tolerance into two categories: the risk tolerance you must accept to reach your goals and the risk you can emotionally tolerate. In other words, the amount of risk you feel comfortable with.

Understanding your risk tolerance helps us choose appropriate asset mixes for your portfolio. An asset mix refers to spreading your assets across stocks, bonds, etc. This exposes your portfolio to varied sources of return and risk.

To determine your risk tolerance and an appropriate asset mix, we must thoroughly understand your financial goals, time horizon, and financial behavior. By assessing these three things, we can build a portfolio tailored to your needs.

Financial Goals

If you are planning to buy a house or retire soon, an argument could be made that this should lead to a lower level of risk. This is because of the time horizon of your financial goals. You don’t want to place assets in volatile, illiquid investments if you will need funds within a short period of time. Inversely, if goals are further in the future, adding additional risk could increase your chances of reaching or exceeding them. If there is variation in the timing of your goals, such as a planned retirement age, and how long you estimate you will live, it is extremely important to continuously review risk levels and adjust when needed.

Historically, market returns tend to average out over longer time horizons. Those with shorter investment horizons don’t have this luxury. Therefore, extra caution needs to be taken the shorter the timeline of the goals. Education costs are a great example of a known timeline. Individuals know when funds are needed and can structure their investment allocation with that date in mind.

Financial Behavior

A big portion of risk tolerance is rooted in your behavioral tendencies. If you see the stock market going down, will you pull your money out? If you are tempted to jump ship when you see a market downturn, you might be more risk averse. If the thought of a market downturn doesn’t bring fear, but instead thoughts of opportunity, you’re likely more risk-tolerant. Investing brings out different emotions in everyone. Therefore, you must understand the emotional biases you’ll bring when making investment decisions within your portfolio.

We understand how critical an investor’s emotional reaction to market fluctuations is. This is why we attempt to align their personal tolerance with the amount of risk they need to succeed. Even the strongest financial plan can quickly be destroyed if an investor is not committed to staying the course.

The Bottom Line

Risk tolerance truly depends on the investor. Consider your short and long-term goals, behavior tendencies, and time horizon. If you aren’t sure what your tolerance looks like, consider scheduling a discovery meeting with us. We can work through your unique circumstances and develop a portfolio recommendation that suits you.