CFA Montréal

INVESTMENT PRINCIPLES

INFORMATION SHEET FOR INVESTORS

THE INVESTOR'S TOLERANCE FOR RISK

7

IMPORTANT NOTICE

The term "financial advisor" is used here in a general and generic way to refer to any duly authorized person who works in the field of financial services, including the following:

- Investment brokers
- Mutual fund brokers
- Scholarship plan dealers
- Exempt market dealers
- Portfolio managers
- Investment fund managers
- Life insurance agents
- Financial planners (F.Pl.)

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THE INVESTOR'S TOLERANCE FOR RISK

We often think of risk as the likelihood of sustaining short-term losses, such as losing 20% or more on a portfolio of 60% equity and 40% fixed income in 2008. However, risk is also about not meeting our long-term goals, such as failing to reach a specific level of expected income at retirement. It is a challenge to reconcile both risks. Reducing the likelihood of short-term losses requires running a lower risk portfolio, while achieving higher expected income at retirement requires running a higher risk portfolio. It's a delicate balance.

UNDERSTANDING OUR FEARS

Research has found a high correlation between risk aversion and anxiety. Most individuals are emotionally involved when they invest their own personal savings. Often, investors are asked a few questions to evaluate how much risk they can sustain and which type of portfolio is appropriate to them. These questions usually fall into three categories:

- *Personal and financial situation.* It is generally assumed that younger individuals with higher current income and those with greater wealth have a higher tolerance for risk;
- *Objectives and risk tolerance.* A long-term objective justifies a riskier portfolio. But no matter what your personal and financial situation is and no matter what your goals are, some individuals feel anxious about the possibility of sustaining financial losses. Furthermore, when such losses occur, people may act rashly or unwisely. When asked questions to probe tolerance to losses, the same individual may answer these questions differently if asked during a financial crisis, such as 2008, or during a bull market, such as 2013. Investors may also answer differently depending on how the question is framed. For example, will someone answer similarly if asked: "How do you feel about losing 10% of your assets over 12 months?" vs. "How do you feel about

losing $100,000 over 12 months?" What if these same questions were asked after the market had risen by 20% or declined by 20%?

- *Investment knowledge and experience.* It is important to set appropriate goals and have appropriate expectations. However, there is nothing worse than believing we know more than we actually do. This is often the greatest obstacle to the implementation of a long-term financial plan. For example, some investors believe they can time the market or identify the next Alphabet (better known as the parent company of Google).

Some of these questions refer to the risk capacity of the investor: the level of portfolio risk which is appropriate considering the personal and financial characteristics of the investor and his or her goals. Others refer to how the risk tolerance of the investor may be impacted by other less tangible factors.

Such an approach has not always been successful in helping investors understand their own true tolerance to risk. For example, recent research finds that risk tolerance is better evaluated by considering the past behavior and actions of investors, their career path and sources of social influence (family, friends and colleagues) than by asking hypothetical questions about expected behavior in specific circumstances. It is a challenge to be truly honest with ourselves when asked about our risk tolerance.

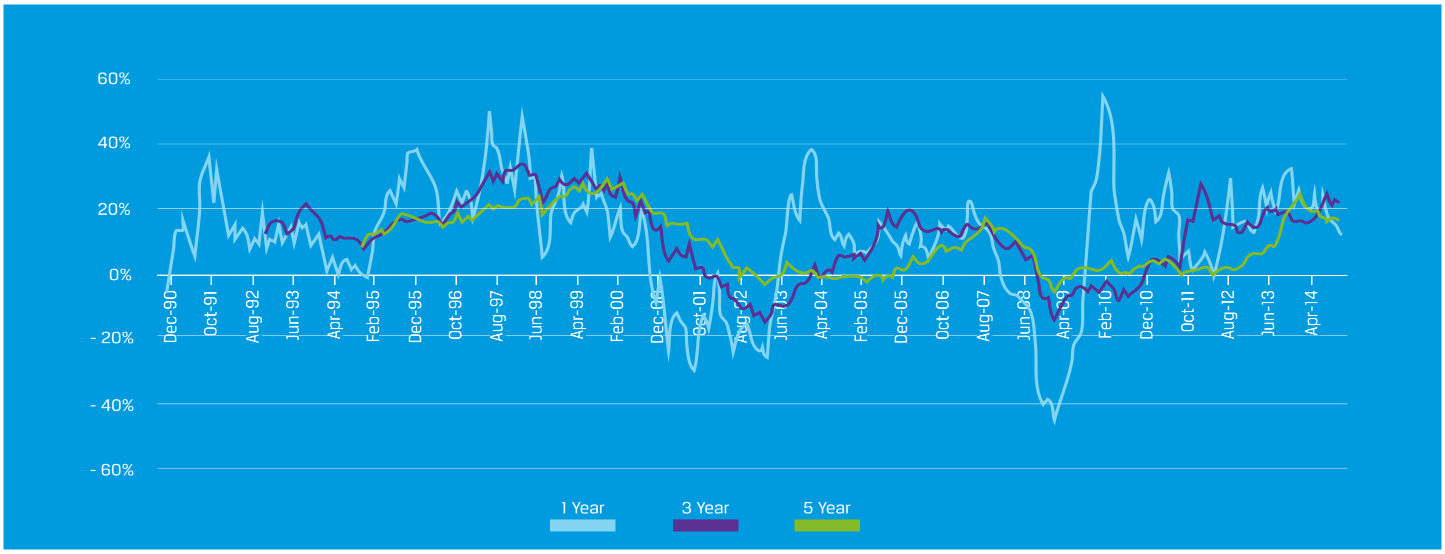
EDUCATING INVESTORS

Investors have anxieties because financial security is a deeply felt concern and because most investors have a limited understanding of financial markets. Furthermore, risk-averse individuals are prone to believe, on average, that bad outcomes are more likely to occur and are worse than they really are. How could this not be the case when the average investor is bombarded with news from "experts" forecasting the next doomsday scenario? We tend to have a greater fear of things we don't understand.

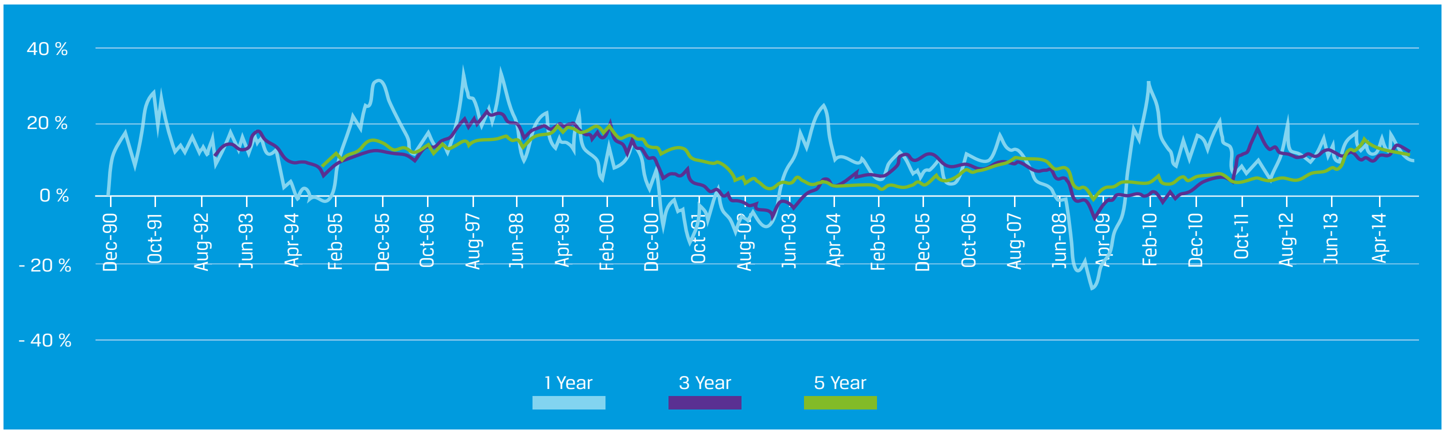
There is only one approach to this issue: financial education (which is the goal of these documents) and guidance from your advisor to help manage anxiety. It will not transform a risk-adverse individual into an aggressive speculator (that is certainly not the goal), but it may help the average investor select an appropriate path and remain disciplined.

For example, although history usually does not repeat itself, it is a good teacher of the dynamics of financial markets and the benefits of diversification. Consider the following two graphs. The first illustrates rolling annualized 12, 36 and 60-month returns since 1990 for US equity. For example, the rolling 12-month return as of December 2000 simply represents the realized return between December 1999 and December 2000, while the 36-month return as of the same date represents the annualized compounded return between December 1997 and December 2000 and so on. The second figure presents the same information, but for a 60/40 portfolio of equity and bonds.

ROLLING EQUITY PERFORMANCE



ROLLING 60/40 PERFORMANCE



The equity figure shows that significant losses do happen when we limit our window of observation to 12 months. But circumstances are not quite as gloomy when longer horizons are considered and/or if the portfolio is diversified with equity and fixed income. Some investors will point to the lost decades of the Japanese equity market, but this is exactly why we must diversify among geographies and asset classes. As long-term investors, we must learn not to be obsessed with the performance of our portfolio on a daily, monthly or even yearly basis. We must also resist the fads that often lead to buying expensive assets. More on this in the next two documents.

SUMMARY AND CONCLUSIONS

Having some anxiety when our portfolio performs badly is natural. Evaluating how much risk an investor can tolerate is also a challenge. Often we may be asked questions to determine how to invest either when markets are calm or when markets are volatile. The answers may be wrong in both cases if such a process is not accompanied by an educational effort designed to help us understand our fears. Education will not make us completely immune to anxiety, but it will help us rationalize that the long-term planning process we have set in motion is based on an understanding of market dynamics. It may help us stay on the correct path.