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F.I.T. Focus – May 2019

What's Your Speed Limit for Investing?

Finding your personal "speed limit" for investing is a crucial component of long-term investing and financial planning success. Where we see investors often go astray, is when they are placed in a "high speed" portfolio that may have a higher potential return over the long-term (*because who doesn't want more return*) but has more potential *downside in the short-term* than they can handle or need to take. This situation is akin to Miss Daisy getting into a car with Vin Diesel (from *The Fast and the Furious*), as opposed to Morgan Freeman. It's probably not going to end well for either of them. One of our most essential jobs is to align investors with portfolios that they can stick with through good times, but most importantly, through more difficult times. To do this, we utilize a framework called the *Risk Number.*

The Risk Number: Your Investment Speed Limit

The *Risk Number* is a numerical framework that aims to measure an investor's tolerance for taking risk. Specifically, the risk number focuses on how much *downside risk* an investor can tolerate over a 6-month period of time, before the potential dollar losses in their portfolio become unacceptable for them to handle. A 6-month time horizon is used because humans don't typically "panic" over multi-year timeframes, and we feel it reasonably captures a timeline whereby one may consider bailing-out on their long-term strategy in the face of short-term portfolio losses.

The best way to think about a *Risk Number* is like a speed limit. On a scale from 1 of 99, the greater the potential loss, the higher the *Risk Number*. Lower Risk Numbers have lower potential returns over time, but less risk and downside. If you can only stomach a 2% loss over 6-months (the equivalent of 4% over a year), your risk number might be in the low 20s. Higher risk numbers have greater potential returns, but more volatility and short-term downside. If you can accept an 18% loss, your risk number might be in the 80s. Let's take a look at a real-life comparative example to demonstrate how the *Risk Number* may be used to align potential investors with their speed limit for investing.

Two Clients, Different Speed Limits, Both Cruising

Family #1 is a married couple with three kids, and over the years had accumulated $430,000 across various retirement and non-retirement accounts. Both spouses work and they actively save money in their retirement plan and additional funds in their taxable accounts. After taking the risk number questionnaire and having a discussion with us, they arrived at a risk number of 59. This means that over a 6-month period they would be comfortable risking a loss of approximately -12% or $52,000 in exchange for the chance of making a gain of 19%, or roughly $80,000. We felt they were comfortable investing at a moderately high speed.

Additional discussion determined that they would invest their long-term, retirement-related savings to be consistent with their risk number. We designed a portfolio with an allocation of roughly 65% stocks and 35% bonds, which may give them a good chance of achieving investment results that keep them within their 6-month comfort zone over time. With their additional after-tax savings, which might potentially be used over a shorter time horizon, they decided to take less risk and implement a balanced allocation of 50% stocks and 50% bonds. The exercise aims to align their investment strategies with their potential planning objectives in a more targeted fashion.

Family #2 is a couple in their 60's that was ready to retire within a year or two when we first met them. Along with their projected pensions and social security, they also had approximately $430,000 in their retirement accounts. After taking the risk number questionnaire and consulting with us, they landed on a risk number of 41. Over 6-months they would be comfortable risking a loss of approximately -7% or $30,600 in exchange for the chance of making a gain of 12%, or roughly $50,500. As a result, we designed a portfolio of approximately 65% bonds and 35% stocks, the inverse allocation of the family above. With lower risk, they may have less upside potential, but also less downside then family #1. The resulting portfolio took into account both their desire to assume risk and their need to take it, given their financial plan and proximity to retirement.

Two families, similar sized accounts, distinct financial planning needs, different "needs for speed", and therefore, personalized investment approaches that align with their comfort levels.

What's Your Speed Limit?

We've just been through an interesting and instructive 6-month period. The stock market cratered in December, delivering some of its worst returns since the financial crisis. As the calendar turned and we now sit here in May, the market has bounced back admirably, albeit with some wobbling in recent days. The steep declines of December (and of late) are recent enough to help us remember what downside risk looks like, while the continuation of the long bull market in stocks also reminds us of the long-term rewards of investing. How fast do you feel comfortable driving your portfolio? We believe now is an excellent time to revisit and find out.

If you have any questions regarding this report, please contact us at info@today2b.com or 914.302.3233

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