

Drawing Conclusions from the Risk Tolerance Questionnaire

1. How would you define yourself as an investor?

a. Babe Ruth was the all-time home run hitter in baseball, but at the same time, he carried the record for strike-outs. An investor who identifies with a swingin'-for-the-fences mentality is likely a Babe Ruth-type of investor. When you're on, you're really on, but when you're off, you're off the charts. You have a stomach for volatility and the faith that in the grand scheme of things you'll do much better than the base-hitter type. If luck and talent are with you, you can make money as this type of investor.

b. The base-hitter investor type isn't swingin' for the fences. She's looking for solid, consistent performance. This type of investor knows she'll sacrifice ever knowing what it feels like to hit a home run, but is willing to because she believes that slow and steady wins the race, which is true in the investment world.

Consistent, positive growth is the most probable way to achieve financial security. You sure don't get bragging rights very often (well, at least not for many, many years), but in the end, you usually come out just right.

c. Switch-hitters match their talent against their opponents'. If the pitcher does worse against a left-handed batter, then the switch-hitter may opt to bat left-handed. An investor who identifies with this characteristic may have difficulty staying with one investment strategy. He may always be on the lookout for a "better way."

d. An investor who identifies with the character who has "never held a bat" has very little or no investment experience. Yet!

2. What amount of your portfolio could you tolerate losing in any given month?

It is not uncommon for the U.S. stock market, as a whole, to drop 10 percent in value in just one month. One individual stock, or the stock market of some countries, loses that much any given day.

If you're fully invested in stocks, you need to be prepared for down days, months, and even years. The more you diversify your stock portfolio the better, but only so much risk can be diversified away. You cannot diversify away all volatility, and at times that volatility can be great.

3. What amount of your portfolio could you tolerate losing in any given year?

Dropping 10 percent in value in just one year isn't at all uncommon for the U.S. stock market. In fact, the stock market commonly goes up or down as much as 1 or 2 percent per day. Too many bad days in a row totals a very bad period.

4. How much could you tolerate losing over five years?

The U.S. stock market has had only one negative five-year period of time in the last 35 years. However, for the most part, these five-year periods were actually some really good years for the U.S. stock market. It hasn't been that positive before, so don't count on it in the future.

Prepare yourself and your investment portfolio for extended down markets. Five years isn't a long time to the stock market. However, when you're living through it, a bad year period feels like an eternity.

5. How much money could you handle losing in any given year?

You shouldn't have any money invested in any stocks if you can't tolerate some chance of loss over an extended period of time. One year isn't long enough to put your money at risk and come out ahead every time.

6. What action would you take if the stock market dropped 25 percent from its present value next week?

Knowing what the "right" answer would be is difficult because the U.S. stock market hasn't lost 25 percent in a week very often. You may not really see this as a legitimate risk; however, a 25-percent drop is extremely likely to occur again and possibly several times during your investing lifetime.

The best response to a drastic drop in the stock market historically has been to raise cash and invest more, but not every time. Sometimes doing nothing is the smarter immediate reaction. Selling everything has historically not been the right thing to do.

7. How many years of your financial independence or security are you willing to risk?

Human beings are naturally risk averse. We don't like to lose, and the pain of losing is more motivating than the pleasure we receive from gains. So how do you know how much financial freedom you're willing to risk?

Say, for example, that you need \$50,000 per year in retirement income to support your standard of living. Your portfolio is currently \$500,000. Are you willing to risk losing 10 percent of your portfolio, or \$50,000, if it meant you would have to work one additional year?

This question is just another way to look at your tolerance for risk. The closer you are to achieving your financial objectives, the more the definition of risk as "not being able to achieve your objective" becomes real. Does your response to this question change the way you responded to previous questions?

8. Regarding your finances, what do you spend the most time thinking about?

a. Are you questioning whether you'll have enough money for the future? Wondering whether you're saving enough? Remember that you'll need a substantial amount of capital to provide the income you may need to retire. You can use the following table to get a ballpark estimate of how much money you'll need at retirement.

Income Needed	Capital Needed
\$1,000/month	\$300,000
\$2,000/month	\$600,000
\$3,000/month	\$900,000
\$4,000/month	\$1,200,000

For each \$1,000 in retirement income you need by age 65, you need to save this amount per month, presuming that you haven't begun saving for retirement in any meaningful way. (For additional information on retirement planning, refer to Chapter 11.)

Current Age	Savings / Month	-Savings as Percentage of Income (approximately)
18	\$48	5%
25	\$86	9%
30	\$131	13%
35	\$201	20%
40	\$315	32%
45	\$509	51%
50	\$867	87%
55	\$1,640	can't compute
60	\$4,083	can't compute

b. -How can you earn more on your investments? Teach yourself and/or hire a professional. Chapter 14 can give you a great head start; other great resources for advancing your investment education include *Investing For Dummies* and *Mutual Funds For Dummies* (both published by Wiley). You can refer to Chapter 20 of this book for tips on finding and hiring the right advisor for you.

c. Could I be doing anything else smarter in regard to personal finances? Your situation can likely be improved upon; I've yet to meet the financial guru who knows every in and out of the financial world. You've already taken a great step by picking up this workbook, but to take your money know-how to the next level, continue educating yourself by reading quality books like those mentioned in this workbook and, when necessary, seek the advice of a qualified professional.