# One's risk tolerance = capacity for volatile equity investing

Money Matters

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Risk is one concept employed when it comes to proper investing, even if it isn't fully understood. I hope to remove some of the confusion around risk here, firstly, by covering the various terms used to describe risk and then, very importantly, defining risk by differentiating between permanent loss and temporary loss of capital.

The three terms typically used in financial planning to describe risk are Risk Appetite, Risk Capacity and Risk Budget:

- Risk Appetite is the risk you're willing to accept for superior returns;
- Risk Capacity is the risk you can afford to take; and
- Risk Budget is the required risk to provide for the objective.

Risk appetite is a subjective, emotionally based personal risk choice influenced by past investment experience, common fears and possibly investment ignorance. That is, an investor may want to invest in cash only after experiencing a loss in the markets.

Risk capacity is an assessment of the amount of risk an investor can take based on investment principles like age, investment horizon and objectives. In other words, a young person should take maximum risk because they have a very long investment horizon and require the best growth.

Risk budget is the mathematical assessment or calculation of the amount of risk or rather exposure to risk assets required to achieve the returns needed to provide for the objective.

Practically explained, the client consults with a Certified Financial Planner (CFP®) who determines the required risk budget to provide for the client's objectives using long-term historical asset class returns. The risk budget is then checked against the client's risk capacity to ensure there is no conflict. You could have a situation where the client's objectives are too great for the funds available, necessitating an unsuitably high-risk budget for the client's risk capacity.

The final discussion around risk focuses on the client's personal risk tolerance or risk appetite. Importantly, this is the "tail of the dog" and the "tail" should never wag the dog. In other words, an appropriate risk budget should not be changed to match a client risk appetite, unless the client understands the affect it will have on the objectives – ie a lower risk budget=lower returns=lower objectives. Basic online robo-advice seeks to match a clients' risk profile with the matching risk budget as required by the act, however akin this is to telling your doctor what ails you and prescribing your own medicine.

An investor's personal risk tolerance is important to ensure he or she can stomach the volatility associated with equity investing. It is important to differentiate risk between permanent loss of capital and temporary loss of capital associated with short-term volatility. Temporary losses always recover over time, so the only risk of losing money is if the investor panics and sells, thus realising the paper loss.

Thus, one must ensure the investor's personal risk appetite and risk budget are in line. If not, the clients' attitude towards risk must change or the objectives and risk budget must be reduced. Investors must be honest with themselves; it helps to have a good adviser to provide rational financial advice on volatile markets, ensuring the investor doesn't panic and sticks to the investment plan. - *www.markwilliams.co.za*