An Appropriate Amount of Investing Risk

[Editor's Note: This is an article I wrote for [ACEP NOW]() on how to select the right level of investment risk to reach your retirement goals. This is difficult for many investors and a worthy subject for discussion. The original article can be found [here]().]

Q. How Risky Should I Be With My Portfolio?

I don't like watching the value of my investments going up and down—it feels like I'm in a casino sometimes. How much risk should I be taking with my portfolio?

A. The more investors learn about investing, the more they realize it's all about risk management—and the risks you face matter far more than the past or projected returns of the investment. In the words of Will Rogers, "I am not so much concerned with the return *on* my capital as I am with the return *of* my capital."

However, it's also important to not take on too little

investment risk, as one of the most significant risks an investor faces is shortfall, or running out of money in retirement. The lower returns available on lower-risk investments may not allow your money to grow fast enough for your needs. There's a reasonable range of risk for an investor to appropriately take, but there are far too many investors whose portfolios fall outside of that range.

RISK VERSUS REWARD

The amount of risk you take should be directly related to your need and ability to take risk. Most investors have a significant need to take on risk, but there are some who do not. For example, an investor with a $10 million portfolio who needs only $100,000 a year from it can eliminate almost all significant risk from the portfolio and still meet goals. Most investors, however, aren't nearly as fortunate. An investor with a $1 million portfolio who hopes to spend that same $100,000 per year needs to not only continue to add to the portfolio but also to take significant risk with it.

Risk Tolerance

Likewise, it's critical to not exceed your risk tolerance. If you don't have the emotional and financial ability to withstand a 50 percent drop in your assets (and few do), a 100

percent stock portfolio probably isn't for you because once every 30 to 50 years or so, the assets of stock investors take a 50 percent haircut.

Save More Money

One of the best ways to lower the amount of risk you need to take is to save more money. Saving more of your income now has a double positive effect on your portfolio: Not only does it grow faster but the amount of income it needs to provide you to maintain your pre-retirement lifestyle is also lowered. Consider an investor who makes $200,000 per year and is saving 20 percent of gross income in hopes of retiring on an income of $160,000 per year, including $30,000 per year of Social Security benefits. Using a 4 percent inflation-adjusted spending rate in retirement, that investor needs to work and save for 33 years prior to retirement. By instead saving 40 percent of gross income and planning to live on $120,000 per year, including a $20,000 Social Security benefit, the investor now only needs to work and save for 19 years, which equals more than a decade of extra time in retirement.

Inflation Danger of Low-Volatility Low-Return Investments

Many investors prefer to invest in very safe but low-returning investments like CDs, bonds, savings accounts, and insurance-based products such as whole-life insurance. These investments appear to be safe because the returns aren't volatile like those of higher-returning investments such as stocks and real estate. In reality, though, they can be even more dangerous. Perhaps an investor's greatest opponent is inflation. Even inflation of just 2 to 3 percent a year presents a formidable threshold to investments that yield only

1 to 2 percent a year. Nobody likes to see their investments drop dramatically in value, but the alternative is to be forced to spend less than you would have otherwise in retirement or face running out of money if you live long enough. Investors who prefer low-volatility investments have likely never run the numbers to really understand what their investment preference means.

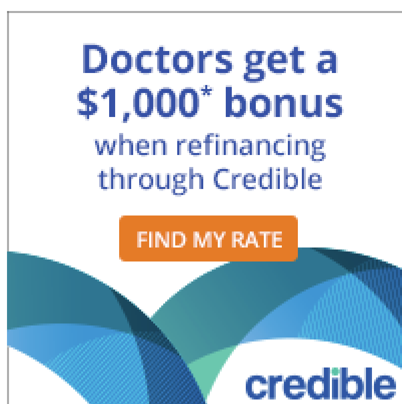
For example, an investor who wants a portfolio to provide 50 percent of pre-retirement income but who achieves an investment return that only matches inflation (0 percent real) and wants a 25-year career will require a savings rate of 50 percent of gross income for each of those 25 years. Very few doctors are willing to save that much of their income. Alternatively, the investor can work for 40 years while saving 31 percent of income. A more risk-tolerant investor who achieves a return that beats inflation by 5 percent, on the other hand, would need to save only 25 percent of income for 25 years, or 10 percent of income for 40 years, to have the same retirement spending level. The bottom line is that almost all investors need to take on a significant amount of risk in order to meet their financial goals.

What is A Reasonable Amount of Risk?

Phil DeMuth, PhD, managing director at Conservative Wealth Management, LLC, has said, “Even if risk tolerance existed and could be measured accurately, why would it be an important factor when considering how to invest? You should invest in the way that has the greatest prospect to fulfill your investment goals. That might mean taking more or less risk than you would prefer. If you are a sensitive soul who can brook no paper losses, the solution is to get a grip, not to invest ‘safely’ if that locks in running out of money when you are old.”

There are many investing “products” (most of them insurance-based) that are marketed as reducing the risk in investing. However, these same products are also likely to reduce the return so much that a typical investor cannot afford to have any significant chunk of a portfolio in them. Financial theorist William Bernstein, MD, said, “There are no free volatility-reducing lunches that will inexpensively reduce your portfolio risk, and there is no risk fairy to insure the risky parts of your portfolio on the cheap. Yes, there are people who—and vehicles that—will do this for you, but they will cost you a pretty penny.”

While the general adage that higher risk equals a higher return is true, you should be aware that you won’t be compensated for taking some risks. A risk that can be diversified away is, by its very definition, uncompensated risk. An example of this is investing in a single stock or even a handful of stocks. Since you can easily buy all of the publicly traded stocks in the world using low-cost index funds, you won’t be paid an additional risk premium for investing in a single stock—even if that stock is Apple.



A novice investor may ask, “What’s a reasonable amount of risk to take in a standard portfolio of low-cost, broadly diversified stock and bond index funds?” Many decades ago Warren Buffett’s mentor, Benjamin Graham, recommended never holding more than 75 percent or less than 25 percent of your portfolio in stocks, with the remainder in bonds. I think that

wisdom still holds true today, and you should have a very good reason to go outside that recommendation. If you do decide to leave the relatively safe confines of the publicly traded markets for your investments, limiting risk should be of the utmost importance in evaluating a prospective investment.

Owning stocks, bonds, and real estate isn't gambling. You're loaning money to or owning small pieces of real profit-generating enterprises, some of the largest and most successful that the world has ever seen. Make sure the amount of risk you're taking on isn't too much, or too little, to reach your goals.

How did you determine how much investment risk to take? Has that changed over the years? How and why? Comment below!