

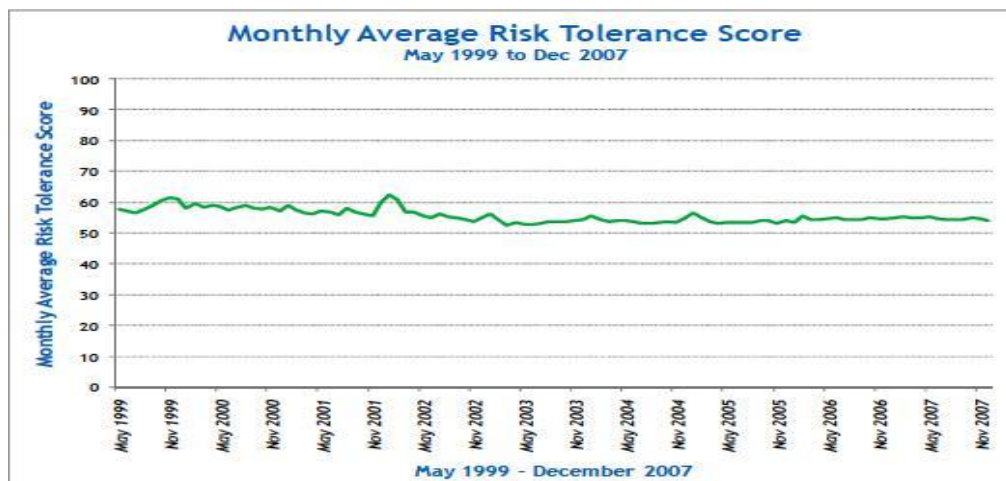


Has Your Risk Tolerance Changed?

As financial planners, one of the most important roles we play with our clients is preventing them from executing destructive behavior at market extremes. Perhaps no time in the last 50 years has this responsibility been more apparent than it has been over the past decade as we've swung from what Alan Greenspan called the "Irrational Exuberance" of the late 1990s to what some in the media are now calling the "Great Recession". At these extremes, it can be tempting to set prudent investment plans aside, but with discipline, patience, and time, I think we'll all see that sticking with your plans is the surest way to achieve your long-term goals.

That being said, it is instructive to see how this last decade has affected our appetite for risk. As you may remember from past conversations, there are three important drivers that help shape our investment plans: risk tolerance, time horizon, and required rate of return. Understanding these three variables is key to developing a sound investment strategy. In this article, I'd like to take a look at risk tolerance, and more specifically, how this past year may have impacted this important attribute.

As you know, we use the FinaMetrica™ Risk Profiling system to help measure risk tolerance. FinaMetrica™ is systematic about data collection, conducts ongoing studies to constantly improve their understanding of risk tolerance, and shares interesting insights about their system. One of the conclusions they have come to is that an individual's risk tolerance doesn't change too dramatically over time unless impacted by major life events. For example, below is a graph showing average risk tolerance scores from May 1999 through December 2007:

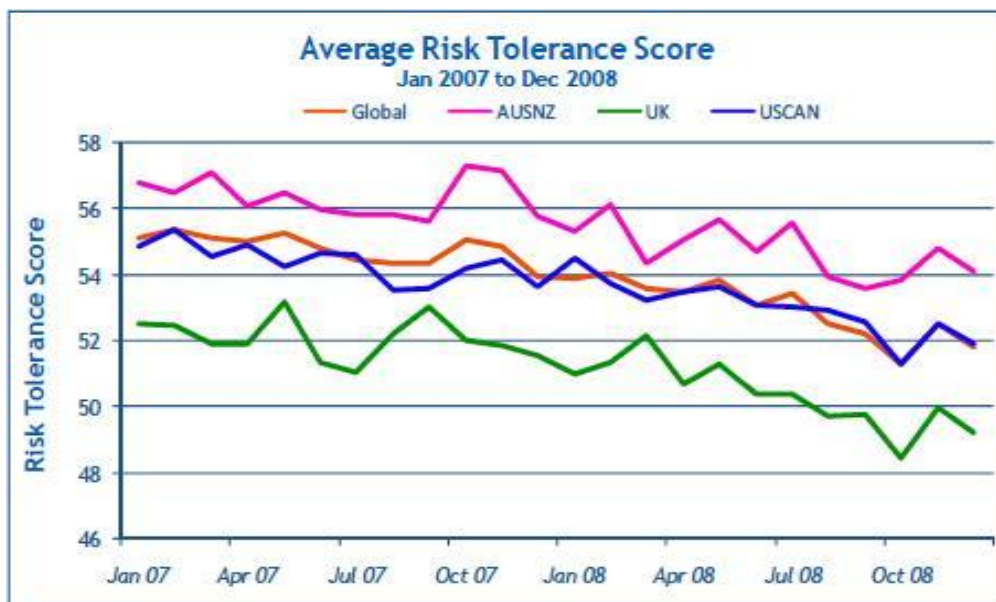


While it appears that there is a slight downward trend in the graph, the analysts at FinaMetrica™ believe that this trend is actually the result of adding new countries to their database (Australia, New Zealand, the United States, and the UK) over time. US data was added in 2002, and UK in 2004; both countries have slightly lower mean risk tolerance scores than Australia and New Zealand.

FinaMetrica™ has overlaid a proxy for the world stock market's performance over this same period of time (as shown below). Given that this period includes both a major recession and recovery, their conclusion is that average risk tolerance scores remained remarkably steady in spite of market movements. But we know that client behavior changed at various times during this decade -- when markets were going up, clients were risk-seeking, and when market were going down, they were risk-avoiding. So if risk tolerance wasn't changing during this period, what can explain changing investor behavior? FinaMetrica's theory: it's the perceived riskiness in the equity markets that explains these behavioral changes.



FinaMetrica™ has looked at this data for the current economic crisis as well. They looked at risk tolerance scores between January 2007 and December 2008, and as seen below, found a fairly consistent drop in average scores that can't be explained by geographical differences.



It appears that the average risk tolerance score across all countries measured has declined by about three points. While this small of a drop (less than 1/3 of a standard deviation) may not have a material impact on the advice we provide, it is important to understand what is driving this trend. FinaMetrica™'s researchers suggest that for some people, the current recession and market declines might qualify as a life-changing event. For others, the perceived risk of the stock market may have changed. They don't have clear answers for us yet, but are testing new questions and evaluating other survey data relating to this crisis in an effort to get at those answers.

At this point, we feel that it's prudent to retest our clients' risk tolerance before their annual investment meeting to see what, if any, adjustments need to be made to their investment plans. While we don't expect any radical changes, we do think it is a good time to re-calibrate our bearings and make sure our clients are taking on a level of risk they understand and can live with.

--Joe Hebert. Posted 05/18/2009.