Know Thyself: How Your Needs Will Steer Your Decisions

Step 1: What Do I Need to Consider Before Investing?

There are four basic aspects that compose your personal investment profile:

- Your personal tolerance for risk
- Your return needs and whether you need to emphasize current income or future growth
- Your time horizon
- Your tax exposure

Each aspect of your personal investment profile will affect the trade-offs you are willing to make and your ability to reduce risk.

Step 2: How Do I Know How Much Risk I Can Handle?

The amount of risk you are willing to take is an extremely important factor to consider before making an investment because of the severe consequences of taking on too much risk. Risk is uncertainty—the possibility that the investment won't perform as expected. Most investors who take on too much risk panic when confronted with losses they are unprepared for, and they frequently bail out at the worst possible time. Stock investors who panicked and sold right after a stock market crash moved out of the market at one of its lowest points. The result—buying high and selling low-is the opposite of Will Rogers' famed investment advice, and is guaranteed to produce an unhappy outcome.

Properly assessing your tolerance for risk is designed to prevent you from making panic decisions, abandoning your investment plan mid-stream at the worst possible time. How can tolerance be measured?

While many questionnaires seek to grade risk tolerance, the best approach is to simply examine the worst-case scenario—a loss over a one-year period—and ask yourself whether you could stick with your investment plan in the face of such a loss.

Investors with a **low** tolerance for risk generally can sustain losses of no more than **5%** over a one-year period. Individual securities with this kind of characteristic include money market funds and certificates of deposit, both of which protect the underlying principal investment with virtually no risk of loss, and short-term bond investments.

Investors with a **moderate** tolerance for risk can generally withstand losses of between **6% and 15%** over a one-year period. Types of securities that may sustain these kinds of losses include intermediate- and long-term bond portfolios and high-quality, lower-risk dividend-paying stock portfolios.

Investors with a **high** tolerance for risk can generally withstand losses of between **16% and 25%** annually. Security types that may sustain these kinds of losses include aggressive growth stock portfolios, portfolios of stocks of smaller firms and emerging market stock portfolios.

Note that the examples of security types are presented merely to give you an idea of the level of losses discussed. If you are drawn to one of those kinds of securities, you probably have a tolerance for risk approaching that type of security. The examples are not meant to limit investors solely to the choices within each risk level. In fact, we shall see later in the series that even a low-risk investor can benefit by diversifying into riskier investments with part of their portfolio while maintaining a low-risk profile. In addition, the losses outlined are typical for the security types as a group; individual securities within these types could sustain losses much greater than a portfolio of securities.

Step 3: How Do I Decide the Rate of Return I'm Shooting For?

Individuals differ greatly in their return needs. If you depend on your investment portfolio for part of your annual income, for example, you will want returns that emphasize relatively higher annual payouts that tend to be consistent each year and protect principal.

On the other hand, individuals who are saving for a future event—a child's education, a house, or retirement, for instance—would want returns that tend to emphasize growth. Of course, many individuals may want a blending of the two—some current income, but also some growth.

Determining your return needs is important because you can't have all of everything—there is no investment that offers a high certain payout each year, protects your principal and offers a high potential for future growth.

There are a number of trade-offs here, based on the risk/return trade-off. First, the price for principal protection is lower returns, usually in the form of lower annual income. There is also a trade-off between income and growth: The more certain the annual payment, the less risky the investment, and therefore the lower the potential return in the form of growth.

These trade-offs can be seen by looking at examples of individual securities from least risky to most risky:

- Money market funds, certificates of deposit and short-term bonds offer the most certain annual payouts plus protection of principal, but offer virtually no potential for growth.
- Longer-term bonds offer higher annual payouts, but less protection of principal and little growth potential.
- High-quality dividend-paying stocks offer less certain annual payouts, since dividends aren't assured, and no principal protection, since stock prices aren't guaranteed, but they offer considerable growth potential.
- Finally, growth stocks offer the most potential for growth, but rarely pay dividends.

Again, these securities are mentioned only as examples of return characteristics to help you identify your own needs. Individuals with specific return needs will not necessarily invest exclusively in securities with those same characteristics. Diversifying among different types of securities in the proper proportion will still allow you to meet your return needs, as long as you have identified them properly.

Step 4: Am I a Long-Term or Short-Term Investor?

The length of time you will or can be invested is important because it can directly affect your ability to reduce risk.

Time diversification is most critical for volatile investments such as stocks, where prices fluctuate greatly over the short term, but are considerably smoothed over longer time periods.

If your time horizon is short, you cannot effectively be diversified across different market environments. Longer time horizons allow you to take on greater risks—with a greater return potential—because some of that risk can be reduced through time diversification.

How should time horizon be measured? Your time horizon starts with whenever your investment portfolio is implemented, and ends when you will need to take the money out of your investment portfolio.

If you are investing to save for a specific event, such as tuition payments or the purchase of a house, your time horizon is fairly easily measured—it ends when you need the cash.

If you are investing to accumulate a sum for periodic withdrawals, such as during retirement, your time horizon is more difficult to quantify as you approach the time that withdrawals will begin. For instance, when you retire, you may need to take out only part of your investment portfolio as income each year. Your time horizon will be a blend—partly short-term, and partly intermediate- or longer-term.

What constitutes short-, intermediate- and long-term horizons?

Time diversification is directly affected by time horizon, so it makes sense to use that as a starting point. Since time diversification is most effective for the most risky investments—stocks—it sets the long-term horizon.

To diversify over various economic cycles, you must be invested through one complete economic cycle at the very least. In general, the economic cycle lasts about five years, which can be considered a long-term horizon. An even longer-term horizon—over 10 years—would cover several cycles and ensure even greater time diversification, which is useful when investing in particularly risky stocks.

What about short- and intermediate-term horizons? Since the horizon is less than five years, stocks shouldn't be considered. In addition, the sooner you need the investment, the greater the need for principal protection and ease of selling.

A short-term horizon—under five years—effectively limits you to fixed-income securities. If you need the money within a year or two, you are limited to the shorter end of the fixed-income spectrum—money market funds, very short-term bonds and short-term certificates of deposit. A somewhat longer-term outlook—two to five years—allows you a little more room to earn higher returns using intermediate-term (less than five years) bonds and intermediate-term certificates of deposit.

Step 5: How Do Taxes Impact My Investment Decisions?

The bottom line to all investors is what's left after taxes. The level at which you are taxed will have a big impact on the kinds of investments that will provide you with the best aftertax return.

Investors who are in higher income tax brackets need to be concerned with the tax implications of their investments. For instance, part of the return from a high dividend-paying stock is in the form of an annual dividend that is taxed each year. High tax exposure investors would want to avoid or shelter in a tax-exempt account, such as an IRA, investments that generate high annual income, and stress those that offer long-term growth, where taxes can be deferred until the investment is sold. If these investors need fixed-income securities, they would probably prefer those that offer some tax exemption, such as municipal securities.

Investors who are in lower income tax brackets need to worry less about the tax implications of their investments. Conversely, they should avoid securities that benefit high tax-exposure investors. For instance, the yields paid on municipal securities are usually attractive only for investors in the top tax brackets.

With the tax laws changing regularly, it is difficult to quantify what constitutes "lower" and "higher" tax exposure (perhaps the terms "high" and "even higher" would be more accurate). However, if your annual income level puts you within the top federal income tax categories, you fall within the "higher" category, and if your income level puts you in the lower federal tax categories, you are in the "lower" category.