

How to assess your risk tolerance



Whether the topic is skydiving or investing, each person's comfort with risk is different. Some may be willing to take higher risks, while others are more averse to risk and prefer greater predictability and safety. When it comes to finances, understanding personal risk tolerance can help you choose the solutions and investments that align with your priorities and financial goals.

What is risk tolerance?

Risk tolerance is how much an individual is comfortable with taking on risk, specifically when it comes to market volatility and uncertainty. Often measured on a spectrum, a person's risk tolerance is how willing they are to take on risk or their openness to possible loss in exchange for a potentially higher return. For some people, the ups and downs of the market may be very stressful, and they do not want their financial portfolio affected by volatility. Others may be able to tolerate loss and prefer financial vehicles that have more exposure to market risk with a greater potential for growth.

How do you measure risk tolerance?

Determining your own risk tolerance is important to better understand your financial mindset and how you can shape your financial strategy to match your goals. Along with using a risk calculator to help determine your current balance with risk and where you fall on the spectrum, you can also explore several key factors that can influence personal risk tolerance:

1. Age

Younger individuals can typically take on greater risk, since they have more time for their financial portfolios to recover from market loss. Individuals who are nearing retirement may want to shift to lower-risk investments and financial vehicles to ensure their accumulated savings remain stable and available once they retire.

2. Financial goals

Each person has a variety of financial goals, and those objectives can change throughout one's lifetime. Whether the goal is to take care of loved ones and have a comfortable retirement, create enough savings for future medical care, or preserve a nest egg rather than grow it, understanding what you're looking to accomplish can help inform the correct amount of risk.

3. Timeline

The time horizon is the amount of time you have until you want to reach a certain goal, like retirement. A longer time horizon usually allows for a higher risk tolerance, while a short timeline often leads a person to seek less exposure to risk. A portfolio can contain several savings goals and timelines and can evolve throughout your life.

4. Portfolio size

Oftentimes, the smaller a portfolio, the less tolerant it is to risk, and vice versa. In general, individuals with more savings and greater financial security may have more freedom to take on risk, while those with less accumulated assets and perhaps higher debt may not have as much capacity to risk loss for a potentially larger gain.

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5. Comfort level

Identifying your risk tolerance also takes exploring your willingness to take risks and your comfort level with loss and investing. Helpful questions to ask yourself include:

- Do financial decisions make you anxious?
- Are you willing to withstand some fluctuations in the market?
- How comfortable are you with potential losses in your investments?
- If the market performs poorly over the next several years, what would you expect from your investments?

What are the risk tolerance levels?

Risk tolerance is typically a mix of personality and financial circumstances, and once those factors are explored in more detail, it can be easier to determine where you fall on the risk spectrum. There are three risk tolerance profiles:

Low risk tolerance

Also known as conservative risk tolerance, people who prefer low risk tend to choose investments and financial solutions that are considered safe and are minimally impacted by changes in the market. Most often, the priority is to avoid losses and protect assets over maximizing gains. While these individuals may want some growth potential, they are likely content with smaller gains and prefer more stability and predictability.

Moderate risk tolerance

Falling toward the middle of the risk spectrum, those who classify as having a moderate risk tolerance commonly want a more balanced approach between growth potential and long-term stability. This person may be more willing to take on some risk and can accept a moderate return potential in exchange for some fluctuations in their account value.

High risk tolerance

Considered the most aggressive classification, being at the high end of the risk spectrum means the person is more comfortable with taking larger risks and seeks to grow their assets as much as possible. This high-risk, high-reward approach is often seen in larger portfolios with a longer timeline, where this person may feel that any loss now is exceeded by potential gain down the road.

Aligning financial portfolio with risk tolerance

Risk tolerance can play a crucial role in developing a financial strategy and choosing the investments and solutions that align with those preferences. When a financial portfolio reflects a person's appetite for risk accurately, there is often less stress about how it is performing and more confidence in their ability to keep financial goals on track. Meeting with a financial professional can be a great way to discuss risk preferences and better understand your own investment mindset. As a financial expert, they can explain which financial vehicles may line up with your personal goals and create a more well-rounded, diversified portfolio. Plus, as retirement approaches, a financial professional can identify ways to revise a financial plan that realigns to changing risk tolerance and protects hard-earned savings for the future.

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