The Difficulty of Assessing Risk

"Risk is good. Not properly managing your risk is a dangerous leap." – Evel Knievel

During the global financial crisis of 2008 - 2009, stock market risk was evident. Many banks failed and governments raced to bail out those that remained; equities fell more than 50% from the 2007 peak; and there were no atheists left on Wall Street. Then, in March 2009, the black clouds lifted, stocks raced higher, and the crisis receded. During the following decade, global stocks gained 145%, stock market volatility fell to historic lows, and risk went into hiding and seemingly was forgotten.

Risk was forgotten, that is, until February of this year. As the coronavirus grew from a Chinese curiosity to a global pandemic, investors' greed turned into fear and complacency turned into panicked action. And risk, after a decade of hibernation, once again made itself known.

In good economic times it is easy to be comfortable taking risk because the prospect of losing money is mostly an abstract idea; it is only when risk turns against you that you get an accurate picture of what your tolerance for risk truly is. Now that the risk of stock market investing is once again out in the open, this is a good time to reflect on how you feel about risk and to decide how much risk you actually can tolerate.

According to David Hulstrom of Financial Architects, there are three components of one's risk tolerance: risk capacity, risk propensity, and risk perception. Your risk capacity is the amount of risk you can afford to take. For example, if you are a billionaire with relatively humble spending habits (like Warren Buffett), you can afford to take a great deal of risk with your investments because even a catastrophic drop in market value will not change your lifestyle. But if you are a person of more modest means and you are approaching retirement, your ability to suffer a significant market decline is limited and your capacity for risk is far lower.

Your risk propensity is your psychological tendency to either seek or avoid risk. Most adults tend to be risk averse; risk tends to make them nervous rather than excited, and this tendency should lead them to tilt towards a more conservative investment portfolio. Some individuals, however, love the thrill of taking risks. These people enjoy skydiving and high stakes blackjack, as well as the excitement of stock market volatility. Riskier investments may be appropriate for them, as they are better prepared to endure the ups and downs.

Your risk perception is your ability to be aware of the risks you are taking, and it is the trickiest element of risk because most people tend to do a poor job of risk assessment. After an adverse event occurs (such as a virus outbreak), we tend to overestimate the risk of a similar event occurring in the future. Conversely, and even more dangerous in an investment context, after a long period of relative calm we tend to extrapolate that calm into the future and assume that it will be smooth sailing forever.

The truth is, most future periods of heightened market volatility will be caused by something other than a virus, and they almost definitely will be caused by something that is unpredictable. So, when assessing your own tolerance for risk, you need to account for the fact that your risk perception might be skewed. You are probably overestimating the risk of recent events recurring in the near future, while underestimating the impact of unknowable future events.

Investment risk is often hidden or forgotten, but recently it has been obvious and everywhere. The reality is that risk is present in both good times and bad, and understanding that risk is a critical element of a long-term financial plan. Now that risk is staring you in the face, this is a good time to assess your capacity for risk, your propensity for risk, and your perception of risk.

Yet keep in mind that this can be a difficult process because none of these risk components are quantitative and they cannot be measured objectively. The best course of action is to make a conscious effort to be aware of risk even when it has been dormant recently, and to seek the advice of a professional advisor to help determine the appropriate level of risk for your goals.

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