



For investors, your risk profile isn't complete until you have assessed both your financial AND emotional risk tolerance.

Our experience has shown that to gain the most useful insights, one must ask the most relevant questions. If you Google “Investment Risk Assessment”, you will find plenty of online surveys that are intended to align an investor’s risk tolerance with their investments. Unfortunately, most of these surveys are inherently flawed because they focus almost exclusively on *financial risk* (i.e. the return you need relative to the likelihood of suffering a loss) without enough emphasis placed on an equally if not more important input into a proper risk assessment process: *emotional risk tolerance* - i.e. understanding how your investments affect you.

Here is an example of a commonly asked question on one of these cookie-cutter Investor Questionnaires:

How much of a decline in the value of your investments could you tolerate? The client’s options range from a loss of 5%, all the way down to ‘more than 20%’.

There are two problems with this question: a time frame is missing. An investor may be more willing to accept a loss if it occurs over a longer period of time than if it were suddenly incurred over a shorter period (or vice versa). Additionally, the question fails to consider the time necessary to recover from a loss. The time frame matters.

The second flaw is that it is extremely difficult for someone to properly assess their risk of loss. We can be sure of one thing: nobody wants to lose money. But experience has taught us that

even though many investors claim to understand that volatility (and hence short-term loss) exists and can harm the value of an investment, when a negative return event actually happens, financial resolve often goes out the window and emotion rules the day.

Even survey questions designed to assess emotional risk tend to focus on behaviour associated with a specific, quantified scenario: e.g. What would you do if your investments went down by 20%? In this case, the questionnaire offers them options ranging from “firing their advisor” to “putting more money into their investments”. How about this - the first thing they should do is fire the person who designed the Investor Questionnaire!

As part of our initial risk assessment process, Solution Wealth has created a multi-dimensional approach to properly understand someone’s emotional risk tolerance. Our approach serves as a crucial guideline to help us build portfolios for our clients. We want to introduce you to a couple of those dimensions.

The first dimension is experiential. In other words, how does the client interact emotionally with their investments? Here are some of the questions we ask:

***Do you worry that your investments are going to go down and not go back up?
Have you been positively or negatively impacted by a previous investment experience?
Do headlines with bad news about the stock market make you concerned?***

The way someone answers these questions is extremely revealing about their emotional approach to investing and can significantly shape how their portfolio should be built.

The second dimension is communication. Many prospective clients tell us that a lack of timely and meaningful communication with their previous advisor is one of the major reasons they are looking for a new investment manager. This speaks directly to emotional risk because a lack of regular investment updates is a leading cause of investor anxiety. Here are some of the questions we ask:

***How often do you check your portfolio value?
What level of detail about your investments makes you feel comfortable?***

A thorough discussion of the mechanics of client/advisor communication makes both parties develop a collective understanding of how emotional risks will be mitigated going forward. We believe the dialogue we have with our clients at the beginning of the working relationship is crucial, which means asking the right questions and focusing more on understanding their emotional risk. In addition, ongoing dialogue is crucial to assess whether investments must be adjusted as emotional risk tolerances change through time.

If you want to learn more about how we use emotional risk assessments to create a very effective investment framework for our clients, please contact me: my direct line is 905-464-0989 or by email bcarson@solutionwealth.com

Also, look for the second half of this newsletter series when we discuss using the outcomes of the emotional risk tolerance discussion to develop the right portfolio mix for the client.