
## Part two of our series ... a real-life example of aligning a client's emotional risk profile with their investments.

In our previous article on emotional risk, we addressed the important questions that an advisor should ask an investor to effectively assess their emotional risk tolerance. Once that process is complete and the advisor has a good handle on how the client psychologically connects with their investments, the next step is to build a portfolio for the client that aligns with their emotional risk profile.

In the process of creating an investment policy and asset mix for a client, of course we need to understand the basics: the amount of money being invested, the return requirement, liquidity and tax constraints, and the underlying financial risks to their well-being. But to create the most appropriate investment strategy for a client, we believe that an emotional risk assessment can be the most valuable input into the process.

To illustrate, let us share our experience with Ms. Jones (real example, fake name). Ms. Jones had a very successful business career running her own communications firm. She invested her earnings back into the business and purchased a couple of real estate investment properties. When she retired, she sold the business and one of the properties – suddenly, she had 'cash' to invest. She met with an investment firm who put her money in a couple of equity funds. A couple of months later, she was not having a great investment experience … she said her emotional state was being influenced by the daily and monthly gyrations of the stock market. Even though she may have said she was willing to accept that the market "goes up and down", in reality, the volatility of this type of investment was not an ideal fit. A proper emotional risk assessment would have warned Ms. Jones of a mismatch between investment mix proposed to her and her psychological preferences.

The great news for Ms. Jones, and all investors, is that there is a wide array of alternative types of investments available beyond the traditional equity or balanced funds that may be more suitable. Specialty investment firms have created funds to allow access to, as examples, private equity, private real estate, and hedge funds. These types of investments have unique risk characteristics and expected return ranges that differ meaningfully from stocks and bonds. In this particular example, part of Ms. Jones account could have been invested in a fund that invests in private equity (i.e. companies that do not trade on a stock market) instead of public equities (i.e. companies that trade on a stock market). Private equity represents the same of type of investment as stocks (owning an equity share of a business), but the values of these types of investments do not fluctuate on a daily basis because the underlying businesses are not being valued every day. Entrepreneurs tend to fit the emotional profile for investing in private equity because they have first-hand experience with the financing, time horizon and valuation process of private businesses.

Ms. Jones might also have a better emotional connection with real estate funds, as she had experience with this type of investment previously and was accustomed to the combination of monthly income and steady appreciation of the property. She may also have felt more comfortable knowing her money is invested in a tangible, real asset. By allocating some of her account outside of the stock market, Ms. Jones could still maintain her return objectives while considerably lowering her monthly volatility.

Another critical element of managing an investor's emotional risk is communication. From the very beginning, it is crucial for an investor to understand the expected journey of each component of their portfolio. This is more than just general performance expectations, which often lack a specific time horizon or measure of volatility. What is needed is a thorough understanding of the potential daily, monthly, annual fluctuations of returns and the factors that are going to affect investment values over the short and longer term. In other words, what can that client expect when they open their monthly statement! If the emotional risk assessment is done correctly, the client should not be surprised by the potential short-term gains or losses as they travel on their long-term journey toward financial success.

One of the driving reasons that Solution Wealth provides access to a very diverse line-up of investment options for our clients – from stocks & bonds to private equity and private real estate, to alternative income funds and low-volatility absolute return strategies – is so we can always properly match a client's emotional risk with their investments.

At the end of the day, one can never underestimate the importance of the 'sleep well at night' factor. The combination of the right mix of investments and regular communication will make the client and their advisor both have a more restful investment experience.

If you want to learn more about how we use emotional risk assessments to create a very effective investment framework for each one of our clients individually, please contact Brennan Carson at 905-464-0989 or by email bcarson@solutionwealth.com.