Focus on Risk Tolerance
Is Volatility

When the markets collapsed in 2008, investors were really scared — probably more scared than they were in 2001 or even 1987 because the drop was so hard and so sudden. The media seemed to report on virtually every nuance, every little data point. I think 2008 changed an entire generation’s perception of risk. Risk for this generation of investors became more visceral and much more emotional than ever before. What they were really afraid of was the possibility of a permanent loss.

Risk and Volatility

“Risk tolerance” is an important concept for physicians to understand. Because the 2008 collapse was so drastic, it challenged everyone’s definition of what risk is. Many investors exited the market from fear.

The financial industry likes to define risk as volatility or variability. We do this, I believe, because volatility is relatively easy to measure or quantify. The data available for volatility is clean and efficient and helps make the decision making process easier. No matter how good or bad that data looks, advisors need to understand that life tends to get in the way (we saw this in 2008). While volatility is quantifiable and a great tool as an indicator of risk or riskiness, it falls short of providing a true definition of investment risk. I don’t think many investors fear volatility; what they fear is the possibility of permanent loss. When we measure risk tolerance, what we are generally measuring is an investor’s ability to withstand volatility.

Permanent loss is a very different concept from volatility. Volatility only becomes a permanent loss due to one of two reasons: (1) the loss is guaranteed...
when the investor sells during a downturn in the market — generally because of fear; and (2) the investment itself cannot recover — normally due to bankruptcy of the company invested in, for example.

Rationally we all know that we can ride out mere volatility, but permanent losses cannot be undone. The problem with defining risk as permanent loss is that it cannot be measured or predicted.

**The Disconnect**

Investing requires that we buy assets that will be affected by future events, which cannot be known or predicted. Risk arises when negative outcomes are possible because of those future events. Rational investors seek compensation for the risk of exposure to those negative outcomes.

Physicians need to decide how to position their portfolio for future developments, but they don’t know what those will be. In other words, and this is the disconnect involved with investing: Investing requires assets to be purchased for the impact of future events, but the future isn’t knowable.

**Coping by Financial Modeling**

Not knowing the future doesn’t mean we cannot deal with it. The future needs to be viewed not as a knowable outcome capable of being predicted but rather as the range of possible outcomes. Financial modeling gives investors a tool for coping with the uncertainties of investing.

Financial modeling is not meant to produce a fixed outcome, but rather a range of possibilities. Modeling allows investors to consider many variables simultaneously, including risk tolerance and fear of permanent loss, as well as risk capacity and inflation (concepts we will discuss next month) and determine which possibilities are most appropriate for their particular situation. Financial modeling is a process that allows investors to better understand their options while simultaneously gaining a better understand of what risk really means to them. Once this phase of planning is completed, it is much easier to design a portfolio suited to the investor.

**Value of Advice and Financial Modeling**

Collaborating with investors to understand the components of risk (risk tolerance, risk of loss, risk capacity and inflation) and examine what outcomes are possible is one of the most valuable and important services an advisor can provide to investors. The modeling becomes a plan upon which to construct the portfolio, and serves as a safety net during turbulent markets.

Financial modeling gives investors something concrete to hold onto during turbulent market conditions. It also provides a solid foundation so concrete goals can be set and measured regularly. In my experience physicians generally tend to be more analytical than many other investors and tend to look at the market with less emotion. I find that a solid plan often provides physicians with the analytical foundation necessary to view their portfolio more objectively, and the security to look beyond volatility and focus on their longer-term objectives. Without financial planning and modeling, physicians can be prone to the same emotional disconnect that derailed many investors in the 2008 collapse.

**Questions to Ask**

Below are a few questions to get you started thinking about your risk profile:

- Compared to others, how do you rate your willingness to take financial risk?
- How easily do you adapt when things go wrong financially?
- When you think of the work “risk” in a financial context, what words come to mind?
- Have you ever invested a large sum in a “risky” investment mainly for the thrill of seeing whether it went up or down in value?
- How much confidence do you have in your ability to make good financial decision?

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