

Understanding Your Risk Tolerance

Investing can be a rewarding journey, but it is important to align your investment strategy with your risk tolerance. Understanding your risk tolerance helps ensure that your investment choices suit your financial goals and personal comfort level.

What is Risk Tolerance?

Risk tolerance measures your readiness to handle fluctuations in investment returns. At LOM Blue, we categorise risk tolerance into five levels: very low, low, moderate, high, and very high.

Differentiating Between Risk Tolerance Versus Your Risk Capacity



Risk Tolerance
Emotional
Based on gut check
Determined by anticipated personal reaction to fluctuating investments
Varies with age, temperament, investing experience, financial goals, investment strategy
"How much risk do I feel comfortable with?"

VS



Risk Capacity
Material
Based on current financial situation and investing goals
Determined by projected financial impact of fluctuating investments
Varies with assets and liabilities, liquidity, income, dependents, purpose of investment, investment strategy
"How robust and resilient is my overall financial situation?"

Keeping your goals in mind

When assessing your risk tolerance, it is crucial to define your financial goals to avoid costly errors. Your time horizon, or the planned duration before withdrawing your investments, significantly impacts your risk strategy. Generally, a longer time horizon allows for a higher risk tolerance, as it provides more time to recover from potential losses.

Examples

Below are examples to help illustrate the difference between willingness and ability to accept risk to help you identify which category you may fall into.

1. High Willingness to Accept Risk, Low Ability

Young Entrepreneur: A 25-year-old startup founder with inconsistent income and high financial obligations is eager to take on high-risk investments due to their excitement and comfort with market volatility. However, their limited financial stability and significant debts mean they cannot afford substantial losses, making this high-risk approach financially precarious.

2. High Willingness to Accept Risk, High Ability

Experienced Investor: A 45-year-old senior executive with a stable, high income and substantial savings is both financially and emotionally prepared for high-risk investments. Their ability to absorb potential losses and comfort with market fluctuations enable them to pursue aggressive investment strategies confidently.

3. Low Willingness to Accept Risk, Low Ability

Retiree on Fixed Income: A 68-year-old retiree living on a fixed income from social security and a modest pension is risk-averse and uncomfortable with losing money. Their limited financial resources and need for stable income necessitate conservative investment options, aligning with their preference for stability and low risk.

4. Low Willingness to Accept Risk, High Ability

Young Professional with Inheritance: A 32-year-old professional who inherited a substantial sum prefers low-risk investments despite their high financial ability. Their conservative approach and discomfort with market volatility led them to choose safer investment options, prioritising the preservation of their inheritance and financial security.

Ensuring that your willingness and ability to accept risk are aligned is crucial because it helps maintain emotional comfort and financial stability. When aligned, you are less likely to experience stress and anxiety over your investments.

Steps to Identify Your Risk Tolerance

Here are some actionable steps to help you determine your risk tolerance:



1. Assess Your Financial Situation:

- **Income and Expenses:** Evaluate your current income, expenses, and savings. Understanding your cash flow will help you gauge how much you can afford to invest and how much risk you can bear.
- **Financial Obligations:** Consider your financial responsibilities, such as debt repayments, mortgage and dependents. High obligations might reduce your ability to take on risk.
- **Investment Horizon:** Determine how long you plan to invest before needing to access your funds. A longer time horizon often allows for a higher risk tolerance as you have more time to recover from potential losses.



2. Reflect on Your Emotional Comfort with Risk:

- **Past Experiences:** Reflect on your past experiences with investing or financial losses. How did you react during market downturns?
- **Stress Tolerance:** Consider how you handle stress and uncertainty in other areas of life. Are you generally calm under pressure, or do you prefer stability and predictability?



3. Start Small and Adjust:

- Begin with a modest investment to test your comfort level with risk. Monitor how you feel about the investment's performance and adjust your strategy as needed. Over time, you'll gain a better understanding of your true risk tolerance.

With LOM Blue, we encourage you to retake your Investment Allocation assessment annually to ensure your profile is still aligned with your risk tolerance and goals.