Understanding Risk Tolerance for Investments [Ep. 26]

Transcript

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Diversification is long-term success, right? So, do you have a plan and what are your long-term goals? You have to look at what the long-term plan is. When we talk about diversification in different sectors of the market, we're looking at that long-term plan. Diversification drives long-term success.

(...)

What are your plans for the long-term? All right, you ready? I'm ready. So, today will be an interesting episode. I think Robert, we're going to talk about asset allocation, right? I'm pretty excited about it. Awesome.

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Asset allocation, what that really means, right? It's not just the... Are you picking individual stocks? What sector? But really how emotions complain of that, (...) winners bias complain of that, and why people can potentially have an asset allocation that doesn't even make sense for them. So, why don't you kick us off? What does asset allocation even mean? To me, it's about balancing risk and returns. It's not about being sector specific, right? You want a diversified portfolio that looks at stocks, looks at bonds, real estate, because some of our clients do dabble in real estate.

(...)

All aspects of the financial world and financial picture, you want to diversify. You do not... Don't look at just, "I want to be in tech," or "I want to be in pharmaceutical," or "I want to be in the next meme stock." Now you're getting sector specific. You're putting yourself in this tight little tunnel that you just can't get out of, and it could just mess up your entire portfolio. (...) Okay. And so, how do you figure out your asset allocation? So, what do those steps look like? Is it just a matter of filling out a quick questionnaire? (...) That's a great question. And we talked about this on a previous episode when we look about risk assumptions. 100% of financial advisors do risk questionnaires, but then they just look at your age, they look at your risk tolerance, and they just put you in a cookie cutter model. We've also, talked about how less than 30% of advisors actually build comprehensive financial plans for their clients. So, when we're talking about risk, it's not just about the questionnaire. You have to ask yourself what you're... And be honest with yourself. Be self-aware. What are you truly comfortable with? Because when the market's... In terms of losing money. In terms of losing money. Right. When the market's up and it's doing well, people tend to be more comfortable with risk. Because they're like, "Oh, everything's great."(...) But when everything's hitting the fan and you're watching the news and the market's down 20%, people think they need to get more conservative. And that's the opposite of what they truly should do. So, true examples of what a person should look back on and see how they personally reacted is look at 2008.

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The worst year since the Great Depression. Or 2020 during COVID. During that March and April and May. How volatile the market was. Or even 2022, which was the worst year since

2008. How did you react when the indexes were down 20%, 30%, 40%? Did you look at it as an opportunity to take advantage of that volatility? Or did you get scared and want to go more conservative? (…) Opportunity or catastrophe? Right. There's an emotional tolerance. And that's a fear thing. What we can emotionally withstand. And there's a financial tolerance. What are you comfortable losing in a bad market before you start getting a little antsy and want to make some changes? You need to have those conversations before the volatile market so, you can stay ahead of it. There's always a plan before something happens. Makes sense. And it seems like sometimes people think diversification is overrated because one of the easiest ways, and I'm saying that kind of hesitantly because there's no easy way to make money. But one of the easiest ways if you're attempting to say outperform the market is to be concentrated. The opposite of diversification.

(…)

A lot of people will say you should have five to seven positions if you want to try to outperform the market.

(…)

I would argue against that. I think typically you need at least 30 positions.

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You're going to be fairly diversified. But what would you say to those that don't really believe in diversification because they're saying it's going to hurt your chance to outperform relative to the risk you're taking? There's always a bias that you may have, or you may have a buddy even, that did really well. For all the stories that you heard somebody did well, like you go to Las Vegas, right? They always show you the winners. They didn't show you all the hundreds of losers that paid for that one winner. Right? So, there's always a success story out there. But we said it earlier, (…) diversification is long-term success. Right? So, do you have a plan? And what are your long-term goals? You have to look at what the long-term plan is. If you want to get concentrated for a month or two, or sector specific for a month or

two, or short term, okay, fine. If that, I wouldn't recommend it, but if that's what you're into, do it. But be okay with that type of volatility. When we talk about diversification in different sectors of the market, we're looking at that long-term plan. Diversification drives long-term success. (...) By the way, I know sometimes we'll tell stories about recent experiences. Sure. Just yesterday, and I need to be careful with the company and the client's name, but I was talking to a client just yesterday, an executive at a company that probably you've been, I know you've been to, I know I've been to, and it's a major corporation. Let's put it that way.

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He was telling me, I wish I would have sold some of the company stock, earlier and given it to you, because right now, we're having a good year, right? True. The last, you know, 2023 was a good year, 2024 was a good year. Now 2025, despite the volatility, is a good year. However, he has a significant amount of his portfolio in his company stock. But since he's an executive, he can't always sell it. There's periods of times where he can sell it. Right. It's down 75% for the year.

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75%. While the market's up 15, 20%.

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We were having a conversation yesterday, he goes, I wish I would have sold more in my last period to give to you because it's just too volatile. And I was asking him, I was like, is the company doing okay? Because I wish I could say the name because I guarantee you, if you have kids, I think I know the one you're talking about. And even if you don't have kids, you've probably been there. (...) And, you know, you just, that's a sector bias. Now he isn't sector bias, but we see people that work for companies, they know it's doing well. But then for whatever reason, and I didn't ask him, for whatever reason, stocks down 75%. So, at that point, if the company's still a good company, what do you do? You have to hold it. You have to hold it. Write it back up, then diversify. And of course, that's one of the best things that

can happen for us as advisors is someone to experience that. So, when they come out of it, they understand the importance of diversification, and they don't get the bias on that one stock. To be clear, I hope clients don't lose money by that experience. But you would hope if they lose a portion, because they're concentrated in that stock, that it is a learning experience for them, I guess. That they learn for the lesson. I know we're both parents. And sometimes our kids will not always take our advice, even though we've been there and done it. But when they mess up, I do hope they learn from that experience. Hopefully on a smaller portion of their portfolio. That's right. That's right. You know, when it comes to diversification, I know people oftentimes think of diversifying means you own stocks, bonds, cash, maybe some alternative investments, maybe some REITs. You own some different investments and that's considered diversified. And there's ways to measure that, right?

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That we won't dive into for this episode, but there's ways to measure, are you diversified? Now, that's one way to do it. But there's another within stocks, meaning you could be 100% in stock. So, let's talk about that. Is that even, could that even be wise to be 100% stocks? And how can you be diversified within stocks? Because you could be in 30 stocks, but potentially not be diversified. Earlier, I talked about typically 130, but that's assuming you have different sectors. You have 30 stocks all in technology, (...) or even 100 stocks in technology. That's in one sector. So, you want to talk a little bit about diversification, even if you have a portfolio, 100% stocks? Yeah, there's a misconception that age controls, how much risk somebody should take. That's a good rule of thumb. But as you know, we had a 100-year-old client that passed away a few years ago, but 100-year-old client, when we look at her portfolio, she was 100% stocks. And you might think, why is 100%? Why is a 100 year old lady in almost 100% stocks? What was the money for? Now, is that the story here all the time? No. As people get closer to retirement, they tend to take less risk. They tend to drop their equity exposure, not to zero, but decrease their equity exposure so, they can get more income producing. They go from an accumulation base-- In the case of this example you're giving to a client, they didn't need the funds now. They wanted to leave as much money behind into future generations. Right. She outlived two of her sons, and this money was going to her grandkids that are in their 50s, and her great grandkids that are in their 20s now. And of course, one of them is about to have another child. So, that's five generations we've worked with in that. But that's not the norm. Most people, when they get to retirement or get close to retirement, we talk about the red zone. Five years leading up to

retirement, five years after retirement, that's the red zone. You can't afford to make a mistake. So, for many people that have been accumulating wealth for a 30, 40, 50 year working career,

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they've been saving up. Now they're getting into this distribution phase. So, it's very common, especially when we build financial plans, that the less risk we take, the more their probability of success of achieving their goals works out, right? Because they can withstand a volatile market, which is going to happen. (...) Now let's look at the other side of that coin. Let's look at young investors. (...) Many people think the younger you are, the more risk you should take are the more stocks you should be in. And this goes back to your question.

(...)

You can be in 100% stocks in your 20s, 30s, 40s, and withstand market volatility because you have enough time to recover. But I would still strongly urge people to diversify among many sectors. What happens in our youth is they do look at the mean stocks. They do look at the tech stocks, what's hot out there, what's somebody pushing. That's not even a licensed advisor. They're just, they're on TikTok, they're on Facebook, and they're pushing some fancy stock. They buy into it. So, now you look at their portfolio, and they've got five, six, seven stocks all in the same sector. If that corrects or if that bubble burst, they could lose it all. Now we talked about it earlier. It's a good lesson learned. Hopefully they don't lose a ton, but it's a good lesson learned.

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But then there's the opposite side of that coin.

(...)

Younger investors think they want to take the most risk possible. I've been doing this 20 years, about 18, 17, 18 years ago, right around 2008, 2009.

(...)

I had a roommate. I was in my mid to late 20s. (...) I had a roommate. And I think he was 27, 28 at the time, did really well. Made a few hundred thousand dollars a year. He was doing really well for himself, especially at that age. Well, of course, I was new to the industry, and he gave me a shot, but nothing I could do. This guy, 27 years old, always wanted to be in bonds, (...) municipal bonds, and nothing I could do could change his mind. And I had conversation after conversation, but he let fear make his decision for him. He was concerned about 2008. And I kept arguing the point. 2008 was the worst year we've had since the Great Depression. When do you want to buy it, especially in your 20s while the market's low? You should be throwing everything you have into the equity market in a diversified portfolio.

(...)

Couldn't talk him out of it. Well, look at what the market's done since 2008 or the low of 2009, which was March when the Dow Jones was at 6,600. Now it's over 40,000. A lot of opportunity loss in that scenario. So, to go back to that story you're talking about of your friend in the 90s. Yeah, he didn't want to take a ton of risk. And we could look at it. Yeah, he should have had a lot of his retirement money in stocks because he theoretically should make money over time. We tell clients typically you're going to make money eight out of 10 years.

(...)

But everybody's, every client's a little bit different. And I think that's where the time horizon, the risk tolerance for that person comes into play. Why don't you talk to us about time horizon? How does that affect when somebody needs that liquidity? How does that affect

somebody's asset allocation? And I want to back up too because in his case, a lot of times we have to meet clients where they're at and understand the risk. Even though this is what they theoretically should do, or we feel they should do, that's not for everybody. So, yeah, I mean, you can always play Monday morning quarterback and look back and say, oh, should have, could have, would have. And now 17 years later, we can say that, but still a great guy. He still made some money. He's still doing pretty well.

(...)

But time horizon.

(...)

It's tricky because people get, I think there's some type of fear or anxiety that people face as we get older.

(...)

We start looking mortality in the face, right? When you're 20 and 30, you really don't think about it. And you're not thinking about retirement, but now you're 30, you start having a family, you know, 50, late 50s, 60s, 70s, you start thinking about retirement. (...) And there's this freak out moment.

(...)

And it's real. I mean, we see it all the time where they work for 40 or 50 years and they go from this accumulation phase to this distribution phase. We've talked about many times, and it goes back to having a plan. So, long-term time horizons, as we're talking about with my former roommate, he had another 30, 40 years before he even needed to(...) think about what age he wanted to retire in distributions. (...) So, he had the time to make up in a

volatile market those losses. He had a time that if another 2008 happened, that he could take advantage of that and make it up. (...) But we talked about the red zone for retirees, five years leading up to retirement, five years after retirement, right? (...) You can't make a mistake. If you're 100% stocks or even worse, 100% stocks that sector specific, (...) and we have a 2008 and you're in a sector that sells off even worse than the indexes did, you could destroy your retirement. We have seen that multiple times, not with our clients luckily, because we've protected them against that, but we've seen it in the past. So, it is smart. (...) Again, this is like you like to say, never say never, never say always. But in many cases, as we get closer to retirement, we do want to de-risk our portfolio. (...) But you also, don't want to go from growth, like you are in your 20s, 30s, 40s, 50s. You don't want to go from growth to no growth. Many people think when I get to retirement, I just need to go to bonds, CDs, and cash.

(...)

Well, yeah, I mean, they may have seen their parents do that. And if they're in their 50s, 60s, maybe their parents did that, but they have to realize their parents lived in the late 80s where bonds and CDs were paying double digit returns. If you have tracked bonds and CDs over the past 15 years, they haven't paid much of anything. I mean, you're looking at 2%, 3% at best. Now, because of interest rates, bonds and things are starting to pay a little bit more. But bonds went into an absolute recession in 2022. I mean, they were one of the hardest hit markets in that horrible year. So, if they go from growth to no growth and just focus on bonds and CDs and have no growth in their portfolio, (...) they could have been hit pretty hard and not liking what retirement's looking like right now. Makes sense. (...) I also, think about a mistake in asset allocation would be the rebalancing. That's been all the rage forever. And I can see situations where rebalancing makes sense,

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but I think you want to be strategic. (...) Sometimes people rebalance and they have their software set up where it's going to rebalance for them quarterly or semiannual, regardless of what the market's doing. Oh, the stocks have done poorly, so, let's sell bonds and buy stocks.

(...)

But I think we want to take a more sniper approach. You want to dive into a little bit how we do that and how most people we would recommend to take advantage of the rebalancing. Rebalancing is important, and what it forces us to do is be disciplined.

(...)

If you're raising kids, you want to be disciplined in almost everything we do in life. Be disciplined in working out. Be disciplined in work. Be disciplined in going to church and in your faith. (...) Discipline means a lot to everybody. Well, we want to be disciplined in our finances. (...) So, it forces us, if you're doing a rebalance strategy, and you should do a minimum once a year, if not twice, it forces you to buy low and sell high. What do I mean? How does that really work? Well, let's say you're in a diversified portfolio with many sectors of it, like we would promote you being.

(...)

And one sector is doing really, really well, and you want to take some chips off the table. But you kind of like this ride. Everybody gets a little biased. They get a little greedy, and greedy is not good. Warm Buffett says, (...) be greedy when those are fearful, fearful when those are greedy. That's right. So, take advantage of that upswing in the market, that upswing in the sector. Now, if you don't have a rebalance set up, then you're trying to depend on your emotions. Well, at that point in time, you're being very greedy. So, if you're depending on your emotions, you might miss the boat.

(...)

But let's go back to this. So, let's say you have it set up, and that sector is doing really well, set up to do a rebalance, automatic. And that sector of the market is doing really well. It's going to sell, (...) take those chips off the table. It's not selling all of the position, right? It's

just getting you back in line to what you preset up. Right? We always talk about having a game plan. That was your game plan. If it goes up after a certain amount of time, it automatically sells, brings you back in line to the percentage you want it to hold. Well, where do those profits go? Well, a lot of times, when something's up in the market, other things are down. Well, if you're doing a rebalance, now you're buying the things that are down, the things that are undervalued, under positioned as far as the asset allocation. You're buying those. So, as the market continues to move, your rebalancing is forcing you to be disciplined.

(...)

Makes sense. Thanks for sharing that. Absolutely. Well, this has been a fun episode. I hope a lot of people can see the benefits of asset allocation. It's not about just following that hottest stock out there, but it's about having a portfolio that's invested to achieve your goals. At the end of the day, that's what matters. (...) Yes, returns matter, of course, but we want to look at what is the downside? What is your max tolerance for pain and adjust the portfolio for that to maximize your potential upside? Thank you for sharing any last thoughts, Robert? I would just say make sure that your portfolio matches your goals, matches your risk, and that you have a plan in place. As always, have a plan. (...) All right, you ready for the mail back? I think so. Okay, where's it from?

(...)

Tracy. Where's Tracy live? No location. Was there? No. Okay, we are online.

(...)

If tax laws change drastically tomorrow, what's the process for adjusting my plan?

(...)

I would say, well, let's think about what's happened in the last few years. I mean, if you go back just a year and a half ago, right, there was a large probability(...) that tax laws were going to sunset at the end of this year. The former tax laws, the prior tax laws were going to sunset. So, what did that mean for retirement? Everybody was on their own assumption, even us, that the probability is taxes are increasing. Now, because of the tax bill, those tax laws have been extended. (...) But what we do know is taxes are eventually going to go up. So, there are things we can do to take advantage of it. But to Tracy's question, what should we do if the taxes and read it one more time, because I want to make sure I hit it right. Tax laws changes, change drastically tomorrow. What's your process for adjusting my plan? That's what I wanted to go back to. Rarely, rarely, there has been two times I can think of, maybe there's more, but in the last 25 years, there's been two times where the government changed taxes, which we knew were going to happen, but they retroactive back to the beginning of the year. So, it might have been September where the laws, they came together, Congress came together and made the laws, but then they did it January of that same year, January 1st of the same year. So, they retroactive the tax situation. Now, there's nothing you can really do about that. You can't control what the government does. However, and I'll give you some advice on what you should do, is have a plan. Have a plan for what if scenarios. The things are, when you hear about tax laws, right, we heard about tax laws a year and a half ago for what we were facing this year. Sure. So, make plans before that happens. Make plans before they have the chance to retroactive it back. So, start having the conversations. The moment the government starts talking about tax strategies or tax laws changing, start having the conversations with your advisors immediately just in case that worst case scenario happens. That makes sense. I would add one thing on there too. I mean, I think that makes sense. If she's asking us what we would do, I would add on that, that our plans, our software updates in real time. So, if tax laws changed, we're going to know that. And we can reach out proactively and say, hey, we recommended in the last year, not to do a Roth conversion. I'm just making this an example up. But now it makes sense because tax laws have changed. Or we recommended not to sell these gains in your account, but capital gain rates have changed. So, I'm giving a short answer. You're expanding from big picture from a low level, I would say, to Tracy is we're going to look at the investments, (...) see how that affects our day-to-day, our previous recommendations, because it may have changed. (...) When facts change, our opinion is going to change. So, what we recommended last year may or may not make sense next year. But go ahead, sorry. Well, no, I think that's a very good point. And what I would tell Tracy is the good news is, the retroactive thing strategy rarely happens. Most of the time we have plenty of notice, but you have to have a plan, as you mentioned, you have to have a plan that's sophisticated enough to know those adjustments are coming. I mean, you remember this. So, and not all plans, we've talked about this in a financial planning episode, that not all financial plans

are created equal. Only about half the ones I've ever seen are sophisticated enough to update as tax laws change. (...) Well, last year when we were building financial plans for clients, (...) there was a button, a checkbox in there where we could tell a client, what if tax laws change? What if they're going up like everybody predicted they would? How would that affect my portfolio? And how would our recommendations maybe change? How would they change? So, we're bringing the future into the present, knowing that that's coming. So, definitely have the right technology and the advisor with the know-with-all to make it happen. Well said. Thanks so, much, Robert. Absolutely. Thank you, Tracy, for your question. Keep sending your questions on YouTube or any place that you watch these or listen to these. And we would love to answer your questions going forward.

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