

Your Risk Tolerance: Has It Changed?

By Koji Watanabe, CFP®, Vice President, Senior Financial Planner

For investors of all ages, risk tolerance is one of the most important considerations in managing an investment portfolio driven by their financial plan. Generally, young investors tend to have higher risk tolerances than pre-retirees and retirees. That's because when you're young, you have plenty of working years ahead of you to make, save, and invest your money. As a younger investor, you have a greater tolerance to volatile market swings that can negatively affect your portfolio's performance.

However, this is often not the case if you're at the other end of the age spectrum. Older investors tend to have lower risk tolerances to market volatility. Pre-retirees and retirees can be hurt financially by market downturns more so than younger investors for a couple of reasons:

- They don't have the luxury of time on their side for their portfolios to recover from large or extended market downturns – younger adults investing for decades in the future have many more years and market cycles to recoup their losses and rebuild their portfolios.
- For many pre-retirees and retirees, their investments provide a source of income to spend on daily living expenses and support their lifestyle. Younger adults are in more of a work-earn-save mindset with their investing habits.

Defining risk tolerance

In a nutshell, risk tolerance boils down to how well you're able to handle volatility in your investment portfolio, which includes:

- Dealing with uncertainty and coping with potential declines in the value of your portfolio's assets.
- Educating yourself about the investment option under consideration (because visualizing a loss may be much more than how that loss looks and feels if and when it becomes a reality).
- Understanding that an investment is not a "loss" until it is liquidated.
- Realizing a decline in value may be just part of the path to achieving higher value over the long term.
- Quantifying the potential loss to help you put it into perspective and be more comfortable with the downside risk.

The Importance of a Financial Plan for Determining Risk Capacity

"Working with clients who have gone through the financial planning process with me in the past, I often see them having an "aha" moment when they realize their portfolio may have gone down 12% in 2022; but when they compare the current value back to their 2018 or 2019 numbers, they're still well in the positive range, keeping the long-term perspective in mind.

Having a financial plan that captures one's entire financial picture is a methodical way to align an investor's emotions with their risk capacity."

– Koji Watanabe, CFP®, Vice President, Senior Financial Planner



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Overall, risk tolerance really does equate to understanding what your risk capacity is. For example, if the math says you can still achieve all of your goals despite losing \$25,000 or seeing a 20% decline in your portfolio, it can add valuable peace of mind and comfort to the equation.

How to determine your risk tolerance

The following questions are designed to help your financial professional determine your risk tolerance when making an investment decision — you may want to jot down some notes to prepare for your conversation.

- What are your goals with the portfolio, and how else might you achieve them should the portfolio not perform as expected?
- What is your time horizon (e.g., years until retirement)? Generally, the longer the time horizon, the more options you have to choose from and volatility you should be able to withstand.
- How does a particular investment fit into your overall net worth?
- How well do you understand the mechanics of the investment vehicle(s) you're considering?
- What other sources of income do you have as alternatives?
- How would you react in hypothetical scenarios (e.g., your \$1,000,000 portfolio quickly declines to \$850,000)?

When risk tolerance doesn't align with risk capacity

Undoubtedly, your emotions and peace of mind are important aspects of the equation. Often investors are forced to deal with the emotions around making investment decisions when their risk tolerance doesn't match up with the amount of risk they can actually afford.

If investment decisions are making you anxious and keeping you up at night, then it's time for a change. Ask yourself this: "What level of decline or volatility makes me nervous and triggers my stress?" Answering the question honestly can help draw the lines and set boundaries to determine which investment options should be considered and adjusted.

Steps to de-risk your portfolio

In an ideal setting, you should not have to de-risk or make portfolio changes in response to market volatility. These circumstances should have been factored into consideration prior to implementing your investment strategy. Still, it can be a challenge when market volatility hits right at the time you were expecting to access your investments for important life events (e.g., paying for a child's upcoming college tuition, buying a vacation home, or starting a retirement business).

During extended periods of market stress, there are steps you may want to consider to de-risk your portfolio that will help you stay on track with your financial goals.

With your Portfolio Manager or financial professional, thoroughly weigh the pros and cons of making any changes to your portfolio that alter your original investment plan. As tempting it may be, don't make any rash decisions. As an extreme example, liquidating an all-stock portfolio to cash to avoid the current volatility would come with unintended consequences: transactional costs, trigger unnecessary taxes, and missing out on the potential upswing in the market. Always keep in mind what you're experiencing is likely just a short segment of a much longer timeframe.



Next steps

When it comes to determining your risk tolerance, we can't emphasize enough the importance of working with a Financial Planner, Wealth Management Consultant, or Private Client Advisor. Particularly during turbulent times in the market, our financial professionals are experienced in helping clients diversify their portfolios and reduce exposure to more volatile asset classes.

Contact Commerce Trust today. Discover firsthand how our team can offer guidance with your investment portfolio and implement a wide range of solutions to help fulfill all your financial services needs.

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Koji is a financial planner for Commerce Trust. He is a member of the financial advisory services team, a dedicated financial planning practice within Commerce Trust that provides objective financial advice to clients. Following a thorough assessment of a client's unique situation and thoughts regarding wealth, Koji develops holistic and coordinated plans to help clients meet their short-term and long-term goals as well as take full advantage of various planning, tax and investment strategies along the way. In addition to his current role, he has also served as a private banking relationship manager with Commerce Trust. Prior to joining Commerce Trust, Koji was a client manager with Bank of America's wealth management group. Koji received his bachelor of arts degree from Colby College in Waterville, Maine, and has earned his CERTIFIED FINANCIAL PLANNER™ designation. Additionally, Koji is a member of the Kansas City chapter of the Financial Planners Association. He also serves on the board of Brookside Charter School in Kansas City, Missouri.



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