Share Trading

Your risk profile & tolerance

Introduction

In terms of making an investment, there are many different types to choose from — bank deposit, shares, managed funds, property, coins, gold, artworks, collectables, etc. So, how do you choose? There are many considerations that can make this a complex task.

The potential investment “rewards” are a serious consideration, and some investment types can potentially give significant rewards, whereas can give relatively low rewards. But some investment types can be higher risk than others, and you might not be comfortable with the higher risk levels. It is important to choose investment types that you will be comfortable with — ones that will allow you to sleep at night. Understanding your “attitude” to risk is important.

Have you ever wondered about your “risk profile”, or “risk tolerance”? Are you really as conservative, or aggressive, as you think you are? Are you a risk-averse and conservative investor, or a very aggressive and risk-tolerant investor? Do you think you might like to tackle share trading, but you are not sure if you are cut out for it?

This article in Brainy's series on Share Trading, “*Your risk profile and tolerance”* (number ST-2180), tackles this topic, and includes a type of quiz to help you better understand your own risk profile.

Asset classes for investment

The following are the generally accepted major asset classes in which we can invest:

- cash – with a relatively low risk and low return
- fixed interest (eg. bonds) – low to moderate risk and return
- property – moderate risk and return
- shares (equities – Australian or international) – high risk and return.

Each asset class carries different amounts of risk, and different amounts of reward. The challenge is to spread your available funds across one or more asset classes, and into one or more different investments, to suit your own investment style, and risk profile.

Another complication with investing is whether to borrow funds, and if so, which type of borrowing — eg. personal loan, margin loan, etc.

Financial Risk Tolerance (FiRT) table

Have you ever been to a financial advisor, and had to complete one of those multi-page questionnaires? One where you need to divulge your personal details, and the age of your dependents, and your income level, and the value of each of your assets, and your monthly expense details? Questions like the following:

- Which best describes your current stage of life... young..., with children,... family,...retired?
- What is your investment horizon? (1-2 years, 5-10 years, 10-30 years)?
- How would you feel if your investments shrunk in value by 40% over a month?
- How secure is the income from employment that you use to meet normal living expenses?
- How concerned are you about the liquidity of any investment?

Some of the questions they ask are rather personal; but a lot of this information is needed by a properly qualified financial planner in order to put together a proper and thorough financial plan to help you manage your finances, and achieve your financial goals.

The Financial Risk Tolerance (FiRT) table below is a simplistic attempt to help you understand your relative tolerance to risk, and hence your “investor type”. And you don't need to divulge your personal details to anyone.

With this topic, there is a danger of pigeon-holing people into specific categories — but that is not the intention. With a better understanding of your own risk tolerance, you might be better prepared to discuss your own financial matters with a properly trained and qualified advisor.