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Checking your appetite for risk

Think of investments as a culinary adventure. Are you the type to order the same dish because of its familiarity, even when traveling abroad? Do you try to play it safe with the familiar? Or do you take chances with the native cuisine and sample deep-fried grasshoppers (listed in the menu as “land shrimps”)? Your preference is all about your appetite for adventure… and risk.

Investment options vary according to the risk one is willing to assume. Investment advisers want to know their client’s investment philosophy to evaluate risk appetite. If the goal is just to conserve capital and perhaps get a modest return for income enhancement, the portfolio recommendation will favor fixed-income bonds or defensive dividend-paying stocks.

If the risk appetite is hearty (there are carnivores as well as vegans) the mix may go for aggressive growth stocks that have both high upside potential as well as downside risks. Here are some things to consider with risks.

Cash is not entirely risk free. There is a mistaken belief that cash is the safest form of investment. This conviction disregards inflation and the effect of currency depreciation as in recent weeks. Cash is seldom kept under the pillow, as this will make it too lumpy to allow sleep. Still, interest from even a special deposit account may not cover the twin effects of inflation and foreign exchange risk. So, “parked cash” can also be dented by careless valet attendants.

Opportunity cost needs to be considered. Keeping investments in one form necessarily means giving up potential yields of alternatives. Especially if the present cash hoard is the result of liquidating a position in equities by taking profits or limiting losses, waiting in the sidelines too long entails an opportunity cost. It may mean giving up potential gains from a stock price rally. This opportunity cost consists of foregone profits.

Risk and reward go together. Even the most conservative investor does not keep all her assets in cash. Part is invested in real property, as in the house or condo she lives in. It’s possible to spread the risk and perhaps allocate a portion to riskier equities. To cushion the risk impact, it is possible to acquire only dividend-paying stocks. A dividend track record makes a stock more attractive, especially if it is also tagged along in a rally.

Stock picking can be delegated. It is always helpful to track personal portfolio picking, especially the crucial matter of timing when to buy or sell, against professionally run funds with research teams tracking corporate performance. Can the individual investor outperform the professional?

The equities market with its volatility, as in the recent swoon of the Dow on fears of inflation, has too often been compared to a "casino". This metaphor is too simplistic even if the results in terms of gains and losses can be identical. Bets in a casino are decided by the luck of the draw as there are no underlying fundamentals to give a perspective on the risks being undertaken.

Even after a balanced mix of risks, there is the option of using borrowed funds for investing. The use of margins or loans to buy stocks can exacerbate steep declines in value. It is possible to lose more than the investible funds. Margin calls and redemptions of panicky mutual fund investors can accelerate the selling pressure on the market and accelerate corrections.

The drop of the stock market, even after the supposedly good news of a healthy GDP growth rate of 6.7% in 2017 as well as the passage of tax reform, reminds us that economic good news does not always translate into market gains.

Dips in the composite index price are often considered temporary and perceived as a window of buying opportunities.

Is it time to raise the bet and go "all in" in a correction, or should one simply fold his cards and wait for a better hand? Is the drop in prices a time to jump in; or a fire alarm to head for the exits? Is buying cheap now a way of averaging down or simply a case of catching a falling knife?

These questions are all about the appetite for risk.

Funds for investment should not include funds intended for such things as amortizations for the house, groceries, or tuition fees for the kids. What about the savings for a Mediterranean cruise or the purchase of a third car – can these be considered investible funds? This compartmentalization of cash is called "mental accounting" by behavioral economists such as Richard Thaler. This approach is useful in understanding savings and investments.

In analyzing risk, and its impact, it is good to remember that it's not what you lose but what you still have left that counts. Even the most adventurous investor should limit risk to what he can afford to lose, with a downgraded lifestyle.

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