

Weighing Financial Risk

by Sophia



WHAT'S COVERED

In this lesson, you will learn how financial risk tolerance relates to financial goal achievement. You'll understand how effort rather than luck leads to fulfillment of your financial goals. Specifically, this lesson will cover:

1. Taking Risks

Almost everything that you do during your financial journey entails some degree of risk. **Risk-taking** refers to doing something that involves the possibility of a gain or a loss. Thus, **risk** is the uncertainty associated with any physical, social, emotional, environmental, labor market, or financial activity.



BIG IDEA

For those interested in accumulating wealth (money, real estate, and other assets) over their lifetime financial journey, being willing to take calculated financial risks can be an important internal finance characteristic.

People who are unwilling or unable to be at least somewhat aggressive when making financial decisions tend to fall short of their financial dreams. Of course, this is a generalization. For instance, you might know of someone who inherited a large amount of money from a relative and is set for life without taking a risk. For most people, though, taking calculated risks is essential to reaching financial goals. Strong problem solving skills can help you decide if and when to take those risks.



TERMS TO KNOW

Risk-taking

Doing something that involves the possibility of a gain and/or a loss.

Risk

The uncertainty associated with any physical, social, emotional, environmental, labor market, or financial activity.

2. Financial Risk Tolerance

Risk tolerance is one of those terms that everyone seems to understand, but few can define with clarity. Let's fix that. **Financial risk tolerance** refers to your willingness to engage in a behavior that entails the possibility of

a financial loss. If asked, “Are you willing to invest money in the stock market?” your answer will indicate your financial risk tolerance. If you say, “Of course, I am willing to do that,” your risk tolerance is greater than someone who says, “No way, the stock market is too risky.”



TERM TO KNOW

Financial Risk Tolerance

Your willingness to engage in a risky behavior that entails the possibility of a financial loss.

2a. Financial Risk Scale

Here are a few things you should know about financial risk tolerance:



HINT

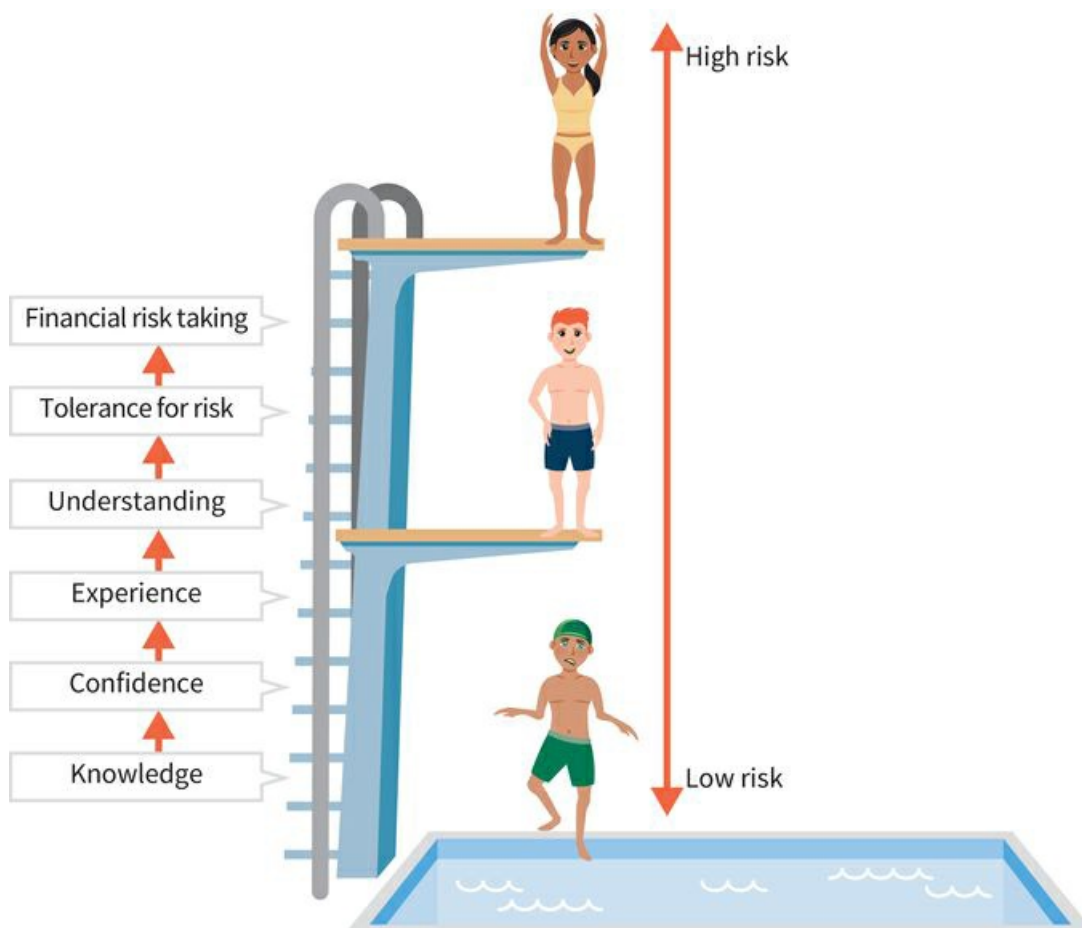
Just because you like to take risks in other areas of your life doesn't mean that you're willing to take financial risks. For example, someone who likes to go rock climbing may not be willing to invest in the stock market.

1. Your financial risk tolerance lies somewhere on a low-to-high risk scale.
2. Your risk tolerance often changes over time. As your financial knowledge and experience increases, your tolerance for financial risk will also increase.

These statements suggest that people who take the time to learn about financial topics and put their new knowledge to work can jump-start their financial journey.

- Financial knowledge creates confidence.
- Confidence helps you engage in new behavior.
- New behaviors provide greater experience.
- Experience produces understanding.

It is this process, as shown in the illustration below, that will help you move up the risk tolerance scale. In turn, this new, higher financial risk tolerance will help you to engage in financial behaviors that usually have greater long-term payoffs.



2b. Luck or Effort?

You might have a friend who says something like, “Sure, those who take risks make more money than others, but really it is nothing more than luck.” The financial plan for those who believe that luck, rather than knowledge and experience, determines financial outcomes often involves gambling, purchasing lottery tickets, or counting on a big unexpected inheritance. It is important that you decide where you stand on this issue.



THINK ABOUT IT

Is your financial future determined primarily by your efforts or by chance? Those who say “chance” typically often make uninformed financial decisions or financial decisions that benefit them in the short run. When they invest, they allocate their money on hunches and whims.



Productivity: Skill Reflect

Remember, those with strong productivity skills find creative, effective, ethical, and evidence-based solutions to economic and financial challenges. They don’t leave things to chance.

Unfortunately, those who rely on chance often fail to do things that build long-term wealth because they don’t believe their actions will influence how much wealth they will have in the long run. They buy things they think are investments but turn out to be assets that fall in value. Ironically, they may even perceive that working hard brings them good luck! Consider the following examples:

➔ **EXAMPLE** Your Uncle Mike buys \$10 in lottery tickets every week. His odds of hitting it big are very (very!) low. He might win \$100 or even \$1,000 every few years, but over time his \$10 “investment” is almost certain to return nothing.

➔ **EXAMPLE** Your Aunt Roberta takes \$10 per week and invests it in a mutual fund that returns 5% annually, a low-risk investment. If Aunt Roberta consistently saves weekly for 30 years, she’ll end up with over \$36,000. Uncle Mike will surely envy those lucky numbers!

Is Aunt Roberta’s wealth based on luck? No way. To achieve this outcome, Aunt Roberta needed to research the marketplace to find a reasonable investment that matched her financial risk tolerance. We will discuss in later chapters where and how to find investment alternatives that match your financial risk tolerance, time horizon, and goals.

3. Financial Risk Tolerance and Wealth Accumulation

Life is full of trade-offs. In the financial marketplace, the primary way to accumulate a certain level of wealth is to take informed financial risks with your savings. You must make a choice between security and uncertainty. This brings us back to financial risk tolerance. Are you willing to be adventurous? Are you willing to make an investment that might lose some money in return for potentially making a larger gain?



Problem Solving: Skill in Action

Mike and Sara waited until their kids were 12 and 14 to start saving for college. They needed to make a decision about how to invest given the short time frame they had. They wondered how aggressive they would need to be. Neither of them were risk takers, but they wanted to ensure the biggest returns on any investment. They used their problem solving skills to determine the right level of risk given the situation.



BIG IDEA

Regardless of whether they are high-risk or low-risk endeavors, you should always understand the risks and potential rewards.

As shown in the illustration below, the relationship between wealth accumulation and risk tolerance is generally positive. So, unless you are willing to take some financial risk, it is going to be difficult to achieve your financial dreams and goals.



- Low-risk investments tend to generate low amounts of investment income and wealth, also known as investment returns, and are very predictable.
- If you want greater returns – which will help you to reach your financial goals – you’ll need to select investments that have more risk or more volatility, and are less predictable.
- Most importantly, you’ll need the risk tolerance to make these investments.

➔ **EXAMPLE** Let’s go back and look at Uncle Mike’s situation. Uncle Mike likes playing the lottery. You can bet that he perceives the risk of playing as being very low. He is wrong. The odds of winning typically are one in millions! In this case, perception does not match reality, and clearly Uncle Mike does not understand the risk.

Lotteries are very risky, yet many people prefer playing. Why? It comes down to financial knowledge. Most people who play simply are unable to grasp the concept of risk and return. Yes, for some, playing is a form of entertainment, but as a financial plan, lotteries are a horrible deal. In the end, it is a person’s willingness to understand and take thoughtful financial risks – with higher potential rewards – that determines long-term financial outcomes.

If your current financial risk tolerance is low, are you doomed to financial failure? Absolutely not! Think of your financial journey as a work in progress. It will take some time to reach your goals. If it’s true that those who are willing to take greater financial risk accumulate greater wealth over time, then it also means that the surest way for you to start working toward your goals is to consider ways to better understand the workings of the financial marketplace. It is through this understanding that financial risk tolerance increases.



Keep learning about financial topics; it can be fun and the payoff is sure to be large.

IN CONTEXT

How well are you able to perceive risks? Make a quick guess to answer this question: From 1824 to 2013, how many years did the stock market generate a positive return for the year?

Answer choices:

- a. The stock market returned a positive annual return for less than 33% of the time.
- b. The stock market returned a positive annual return about 50% of the time.
- c. The stock market returned a positive annual return for more than 67% of the time.

What is your best guess? Based on your guess, do you think the stock market is a wise investment?

If you answered “a,” which is that the stock market had positive annual returns less than 33% of the

time, you likely have a low willingness to take on risk by investing in the stock market. If, on the other hand, you chose “c,” which is that the stock market had positive annual returns at least 67% of the time, you probably have a higher willingness to take on risk by investing in the stock market.

From 1824 to 2013, the stock market actually generated a positive annual return approximately 71% of the time. With this factual knowledge, your risk perception and willingness to take risk may change.



SUMMARY

Financial risk is your willingness to take part in a behavior that might result in monetary loss. For most people, **taking risks** is an inevitable part of financial planning and accumulating wealth. Your first step is to recognize your **financial risk tolerance** and see where your experience and preferences align to the **financial risk scale**. Some might ask whether accumulating wealth is based on **luck or effort**, but the answer is simple. Regardless of your risk tolerance, achieving financial success is often, if not always, based on the effort you put in, and not based on chance!

Strong problem solving skills can help you determine the level of risk that is best for you. By then selecting the most productive strategies, you can ensure success without the added stress of feeling like you have overextended yourself.

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TERMS TO KNOW

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