Larchmont resident Ian A. Post, CFA is the Principal of Fifth Set Investment Advisors LLC. Fifth Set is the result of his evolution of thought in regard to conventional investment management. His experience and education led to research for a smarter approach to portfolio management and financial planning. Prior to Fifth Set, Ian conducted fundamental equity research at Citigroup, Credit Lyonnais and CIBC Oppenheimer. Ian earned a BS in Engineering and Public Policy from Washington University and an MBA with concentrations in Finance and Statistics from NYU and is a holder of the Charted Financial Analyst designation, a member of CFA Institute and a CERTIFIED FINANCIAL PLANNER™ certificant.

Keep Your Eye on the Ball

By Ian A. Post, CFA, CFP®

With the recent upheaval of events nationally and internationally, many investors are asking if current events should impact their portfolio allocations. Thoughtful questions from clients investing new money include, for example, whether they should invest more conservatively if they believe the current political climate will lead to excess volatility.

In answering this question, we need to consider what really matters when designing client portfolios. Some sources of information, both conventional and of the more recent variety, might include economic growth forecasts, corporate earnings estimates, corporate 10K filings, Barron's, Jim Cramer's top stock picks and lately, tweets.

Interestingly, none of these sources of information are necessary, or even helpful, to the portfolio design process.

Rather, the key driver of the portfolio design process is the client's risk tolerance. Matching the client's risk tolerance to the equity allocation of the portfolio ensures that the client's personal situation drives the portfolio risk/return characteristics, not predictions of future (unknowable) events.

Risk tolerance is a combination of two personal risk dimensions. Discussing and evaluating these risk dimensions is crucial to the portfolio design process. By evaluating these risk dimensions, an appropriate portfolio design emerges.

The two dimensions of client risk tolerance are:

- **Your willingness to accept risk**
- **Your capacity to accept risk**

Your willingness to accept risk is: with blinders on, how much downside risk in dollars can I manage emotionally in exchange for the potential to make money on my investments. Your capacity to accept risk is: how will a worst-case downside result on my portfolio impact my lifestyle. Will I be able to meet the financial goals I've laid out for my family if the market falls apart? Going beyond your capacity for risk taking means putting your lifestyle at risk.

Investors who use the dimensions of risk tolerance to design their portfolio such that it reflects their appetite and capacity for risk are more likely to stay disciplined regardless of outside factors or emotion. By stress testing their portfolios using a worst-case scenario[1] investors are less likely to abandon their investment strategy based on emotions and sell equities near the market bottom or make other bad decisions that can permanently damage long-term investment performance.

The key point to remember about these two dimensions of risk tolerance is that they are solely dependent on the investor. There are no outside influences that impact the proper portfolio design decision-making process. Nothing economic, nothing political, nothing from Jim Cramer and no tweets. Keep your eye on the ball by focusing on your personal situation, where you are in your life and how comfortable you are with volatility. Your portfolio should be a reflection of you and your family.

[1] I generally assume a worst-case scenario for equities based on the peak to trough equity return from the 2008 financial crisis which was slightly more than 50% for the S&P 500.