INVESTMENT UPDATES

BUMPY MARKET REMINDS INVESTORS TO ASSESS THEIR RISK TOLERANCE

Do-It-Yourself Crowd Has Quizzes to Rate Courage on Finances

Risk

For many investors, it's a word that has all but disappeared from the lexicon. Throughout much of the 1990s, stocks mostly went up. And even when they went down, many investors saw the slump as just another buying opportunity because stocks soon would go up again.

But the bumpy ride of the past six months finally has woken investors up to the fact that, with stocks more volatile these days than anytime in history, risk is playing an increasingly significant role in their lives.

Did you root the NASDAQ Composite Index higher when it bested 5000 earlier this year, but secretly fear for your overbloated technology shares? Did you panic when the NASDAQ subsequently plummeted in March and April, then kick yourself for not investing more when the market rebounded days later?

These dueling visions of fear and greed reflect the fact that many of today's do-it-yourself investors haven't assessed their own tolerance for risk, captivated instead by the lure of what seems to be easy, almost riskless, riches.

The current, and often myopic, quest for market wealth has spawned "a willingness to take risks that [average investors] haven't had in the past," says Robert J. Shiller, an economics professor at Yale University and author of a new market tome, "Irrational Exuberance." In the process, he says, "investors haven't stopped to think about what risk is at all."

Until the recent market drop, "people had no clue what [risk] is about," agrees Joanna Bickel, a project manager at TIAA-CREF, the big New York provider of retirement services, which is working to bring a more sophisticated risk-assessment tool to its Web site later this year so that its investors can better gauge their own risk profile.

There once was a time when risk assessment was the duty of stockbrokers or financial planners, who questioned clients to gauge their comfort level for volatility and potential losses. But with the explosion of online trading, investors have taken control of their own finances. In the process, they have cast aside the mental due diligence that ultimately determines whether they're sleepless in Cisco or bored by Boeing.

It's an age-old quest for balance. Investors who structure their portfolios so that they are comfortable with both the rewards and risks are the ones who sleep best when market downdrafts keep others awake at night. Moreover, they aren't the ones berating themselves for missing out on big gains when the market rebounds.

To help investors determine the level of risk they're most comfortable with, here's a statistically based risk-tolerance quiz constructed with the help of Investment Technologies Inc., a New York firm that provides investment tools and risk-assessment instruments to financial institutions such as banks and investment firms.

Financial companies increasingly rely on risk quizzes similar to this one, though often far more detailed, to better assess a client's true tolerance for market vicissitudes. As investors continue to take on increasing responsibility for their own money—through online trading or in self-managed 401(k) and IRA retirement accounts—"the issue of how individual investors make investment decisions is becoming a huge issue," says Brian Rom, president of Investment Technologies.

All manner of risk-assessment quizzes are available. Some are posted on financial Web sites, others are available from financial planners and investment companies. Some are relatively simple and are designed to match an investor with particular mutual funds or annuities.

The more sophisticated quizzes are based on statistical research that quantifies the psychological behavior of people and their money habits. Such "behavioral finance" studies have determined that many people typically aren't rational but are irrational when it comes to money and risk.

For example, research has shown that most people fear loss more than they value comparable gain. Offer someone a sure $50 or, on the flip of a coin, the possibility of winning $100 or winning nothing, and chances are they'll pocket the sure thing. Conversely, penalize them $50 to start, then offer a flip of a coin to lose $100 or lose nothing, and they'll invariably take the coin toss. Both scenarios are statistically equivalent, yet people tend to view "the possibility of recouping a loss as more important than the possibility of greater gain," even though the coin flip could mean an even greater loss, says James Corter, associate professor of statistics and education at New York's Columbia University.

The accompanying quiz is based on research done by Mr. Corter. At just eight questions, it is short, but it is backed by empirical studies and "has adequate reliability and validity," says Mr. Corter.

The quiz is designed to reveal where an individual falls along the risk spectrum. It is accompanied by a chart detailing where a variety of stock and bond investments, based on historical performance and volatility, fall along the risk spectrum, to give quiz takers an idea of the class of investments most likely to match an investor's temperament.

Certainly, no risk quiz can tell you everything about your financial courage, and your score here doesn't mean that if you fall into a more conservative category that you can't stomach a little exposure to volatile tech stocks. "But if you answer the questions candidly," says Ms. Bickel at TIAA-CREF, "and don't worry about whether you come out conservative or a swinger, you'll have an accurate portrayal of your risk level that you can use when building your portfolio."