Investors' risk tolerance decreases with the stock market, study finds

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As the U.S. economy slowly recovers many investors remain wary about investing in the stock market. Now, Michael Guillemette, an assistant professor of personal financial planning in the University of Missouri College of Human Environmental Sciences, analyzed investors' "risk tolerance," or willingness to take risks, and found that it decreased as the stock market faltered. Guillemette says this is a very counterproductive behavior for investors who want to maximize their investment returns.

"At its face, it seems fairly obvious that investors would be less risk tolerant when the stock market is underperforming," Guillemette said. "However, this may lead to investors buying when the stock market is high and selling when the market is low. If an investor is only buying when the stock market is up, they are limiting potential returns they could earn from their investments."

For his study, Guillemette and co-author Michael Finke, a professor at Texas Tech University, compared investors' risk tolerance to the Consumer Sentiment Index (CSI.) The CSI is a measure of the consumer outlook on the U.S. economy, including predictions about employment and inflation. Guillemette found that risk tolerance and the Consumer Sentiment Index were positively correlated, meaning that as the outlook on the economy improved, investors were more risk tolerant and as the economic outlook appeared grim, risk tolerance decreased. Guillemette also compared risk tolerance to the price-to–earnings ratio (P/E), which shows how valuable individual companies are. He found that as companies showed more value through their P/E ratios, investors' tolerance for investing in those companies improved as well.

"Also, we found that while risk tolerance followed trends in the stock market, risk tolerance didn't change as much as the stock market," Guillemette said. "So when the stock market dropped by about 50 percent during the recent global financial crisis, risk tolerance dropped by about 7 percent. What this tells us is that risk tolerance is very dependent on the traits and personalities of each independent investor."

To help offset this trend, Guillemette recommends that financial planners create a written investment policy statement with each client that focuses on long-term goals before the client is hit with the panic of a falling market. He also recommends that financial planners work to convince their clients not to look at investment returns too often, as it will help prevent them from selling stocks when the market falls.

"Investors should only purchase stocks for long-term goals like retirement funding," Guillemette said. "Television networks like CNBC and the Fox Business Network sell the misperception that those short-term fluctuations in stock prices matter. However, investors will be much better off if they focus on long-term, rather than short-term returns."

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Provided by University of Missouri-Columbia

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