

When planning for your financial future, understanding both your risk tolerance and risk capacity is key to building an investment strategy that aligns with your personal and financial goals. Though these concepts are often discussed together, they differ significantly and serve distinct roles in shaping your portfolio.

## **What is Risk Tolerance?**

Risk tolerance refers to the amount of market risk you're comfortable handling as an investor. It's a measure of your emotional capacity to withstand losses or market downturns, influenced by your attitudes toward volatility and financial uncertainty. High risk tolerance often translates to comfort with more aggressive, high-growth investments that fluctuate but offer the potential for higher returns. Conversely, if you have a low tolerance for risk, you may prefer stable, conservative investments to preserve your capital, even if that means smaller returns.

To determine your risk tolerance, ask yourself questions such as: 'How would I feel if my portfolio dropped 20% in value?' and 'Have I made hasty decisions during past market declines?' These answers reveal your comfort level with taking on investment risk.

## **Defining Risk Capacity**

Risk capacity, on the other hand, is less about your feelings and more about your financial situation. It's a measure of how much risk you can afford to take based on your income, expenses, responsibilities, and time horizon. For example, if you have a stable income, few dependents, and decades until retirement, you may have a high capacity to handle market fluctuations. However, if you are close to retirement, have significant debt, or financially support dependents, your capacity to handle losses might be lower, even if you have a high tolerance for risk.

Risk capacity can shift with life changes. A new mortgage, a growing family, or a career change can reduce the risk you're able to bear, while a financial windfall or significant reduction in debt may increase it. Keeping track of these factors ensures your investments align with both your financial responsibilities and goals.

## **Matching Portfolio Choices with Risk Tolerance and Capacity**

Investments are generally categorized by risk level, from aggressive to conservative. Below is a comparison of five model allocations designed to match a range of objectives. Each of these models includes a different mix of equities and fixed-income assets, tailored to different levels of risk tolerance and risk capacity.

Investment Objective	Description	Equity % Range	Fixed Income % Range
Aggressive	Built primarily for high-growth potential, this model prioritizes equities and can handle substantial volatility, suitable for those with a high risk tolerance and capacity. This allocation is best for investors with a long time horizon and the ability to endure market ups and downs.	95-100	0-5
Growth	A step down from aggressive, the growth model focuses on capital appreciation while including some fixed-income assets to balance risk. This allocation suits investors with a moderate to high tolerance for risk, aiming for long-term growth without the extremes of an aggressive portfolio.	75-100	0-25
Growth with Income	This portfolio combines growth with moderate income generation, balancing equities and fixed income to capture some upside while managing volatility. It's ideal for investors who have moderate risk tolerance and capacity, seeking steady growth with a buffer against market swings.	50-75	25-60
Income with Moderate Growth	Designed to generate stable income with some growth potential, this allocation leans toward fixed income while incorporating equities to support limited capital appreciation. It's suited to those with lower risk tolerance or nearing shorter-term goals, who still want modest growth.	0-50	60-100
Income with Capital Preservation	This conservative model emphasizes income stability and capital protection, favoring bonds and cash equivalents to minimize volatility. Best for investors with a low tolerance for risk and low capacity, focusing on preserving wealth over rapid growth.	0-30	70-100

### Risk Tolerance and Capacity Over Time

Your personal circumstances and feelings toward risk can evolve, which is why periodically reassessing both your risk tolerance and risk capacity is beneficial. As you move closer to a financial goal, for example, you may want to shift from a high-risk portfolio, such as Aggressive or Growth, to something more conservative, like Income with Capital Preservation, to safeguard your savings.

On the other hand, risk tolerance is often more stable than risk capacity. Some investors remain risk-seeking or risk-averse throughout their lives. However, even those with high risk tolerance may find that a more conservative portfolio aligns better with their needs if their financial capacity declines.

### Building Your Portfolio

Finding the right mix of investments starts with a realistic assessment of your risk tolerance and capacity. When these align with your investment strategy, you're more likely to stay committed to your financial plan, even during times of market uncertainty.

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