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Brett Graff is THE HOME ECONOMIST, a former U.S. government economist and a syndicated columnist who uncovers the subconscious reasons for our spending and saving decisions.

The Home Economist: Know your tolerance for risk

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As the 2016 stock market careens onto a roller coaster, economists on television are excitedly providing viewers with market forecasts for the next 12 months. But whatever their outlooks, certified financial planner Michael Rose from his Miami Beach, Fla., office is telling clients to stick unswerving with the judicious financial plan that he long-ago crafted to reach each one's specific long-term goals.

"People say, 'What do I do now?'" says Rose, founder of Rose Capital Advisors. "And I say, 'Do what I told you from the beginning. Keep a long-term plan, remain disciplined, and periodically rebalance.' Otherwise, it's like when you're on the highway, the other lane seems to be moving faster but as soon as you move, the other lane looks better."

That advice is one of the critical takeaways University of Missouri Professor Michael Guillemette hopes we'll get from his latest research on the psyche behind our stock market moves. He's proven it's our fear of losing money that drives the amount we'll invest. That's a big departure from traditional economics, which has always tied investment decisions to spending meaning the less stuff we're willing to buy today, the more money we'll have to fund our portfolios.

It's an insight, says Guillemette, that can ultimately help us realize bigger capital gains and insure we're invested during the market's most lucrative moments.

"When thinking about how much to invest in stocks, rather than think about the gains, investors should be thinking about the losses," says Guillemette. Then, when the stock market gets rocky, we'll stick with our investments.

To determine this, Guillemette studied the time frame of 2003 to 2010 which captured the pre-recession, major downturn and also recovery periods and looked closely at three ways consumer risk is measured. He examined our spending in stores and online (captured by the Federal Reserve,) our feelings about the stock market (reflected in the Consumer Sentiment Index,) and the stock market's gains and losses as measured by the S&P 500.

In three economic models, Guillemette compared each factor to our risk tolerance as measured by data company FinaMetrica, which captures investor psychology. For the model using the S&P 500, there was one important adjustment: he over-weighted the effect of stock market losses. That's because analysts have long proved that the pain of losing, say, $1,000 is twice as great as the pleasure a person gets from gaining the same amount.

After making the comparisons, he determined that drops in the S&P 500 were closely tied to drops in our tolerance for risk-taking. Those market drops could, says Guillemette, explain about 40 percent of our willingness to invest. When it came to spending, there was no affect on our risk taking. There was, however, a slight relationship between our feelings about the market and our willingness to invest accounting for about 13 percent of these decisions.

"Spending doesn't matter when you're trying to assess how much risk someone is willing to take," says Guillemette. "But the more the market fell, the more risk tolerance fell."

The premise is consistent with findings from Dalbar, Inc., a Boston-based market research firm that sells an annual study on investor behavior. Dalbar took a different approach and looked at what drives our investment decisions, says CEO Louis Harvey. Our spending allocation, he says, is money we've already decided to pay out. When we buy cars we don't expect to get that money back.

"The greatest correlation of when to invest is market cycles," says Harvey. "Just after the market has a substantial rise, people invest more. After the market declines, they invest less."

The problem with that mentality is that it follows financial advisor Rose's lane-changing metaphor. In other words, instead of keeping our eye on the horizon, we get distracted by momentary roadblocks.

Instead, Rose suggest we look at the success of endowments for Ivy League colleges, which tend to outperform that of individual investors. Why? Because decisions are made by committee members that don't get emotional it's not anyone's personal portfolio and therefore take a long term approach, he says. That helps the decision-makers avoid chasing upswings or downturns.

"You should think of your money as a committee would," says Rose.

To that end, remember there are many pieces to the investment puzzle, says Rose, and investments are just one component. Before Rose's clients even invest, he wants them to have plans that include goals and objectives. Not targets such as, say, earning 8 percent a year. But aspirations such as retiring at age 60, maintaining a standard of living based on a set of expenditures or putting two kids through four years of private universities.

"When you're investing with the purpose of hitting those goals, it shouldn't' matter what the S&P 500 is doing," says Rose. "The problem people have and when they lose money by making knee-jerk decisions is being short sighted during periods of volatility."

FEEL THE FEAR, INVEST ANYWAY

Traditionally, economists assumed the less money we were willing to spend in stores, the more we'd put into the stock market. But new research from Michael Guillemette, an assistant professor at University of Missouri, Columbia, proves it's actually our fear of losing money that determines the size of our portfolios. It's an insight that can help us realize bigger gains in the long run. Here's what they can mean to our investments:

Focusing on losses before thinking about gains can help us better estimate our tolerance. "If your losses go beyond the threshold that makes you comfortable, you may not realize any gains because you could sell out and go to cash," says Guillemette. In other words, invest what you're willing to risk, and you'll be less tempted to pull out early.

Viewing our returns quarterly or annually will keep us on track. The constant announcing of market averages and even individual security prices can cause us to stray from our long-term financial plans. "It's detrimental," says Guillemette.

Taking a comprehensive view of our financial plans can also help us stay on schedule. When we see our 401(k) plans have dropped by 20 percent we may forget we have a home that's appreciated in value. "Looking at things in a comprehensive manner tends to reduce knee-jerk reactions," says Guillemette.

Getting a financial plan in writing helps to "increase investor certainly and makes people less likely to jump out of the market," says Guillemette.

ABOUT THE WRITER

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