# ACTIVITY 21.1
# ASSESSING YOUR TOLERANCE FOR INVESTMENT RISK

**Directions:** Each of the following statements presents a situation in which you are asked to decide how comfortable you are with the risk involved. Read each of statements and circle the response that you think best reflects your comfort level.

1. You and a friend are participating in a stock market game. You both have noticed that the share prices of some companies can move a lot, up or down, in any given day. Your friend says: "When it comes to investing, it's scary world out there." When you think about investing your own money, which of the following phrases most likely comes to mind?
   a. Very worried about losses
   b. Uncertain, but ready to plan for investing
   c. Welcoming of a new investment opportunity
   d. Excited about a new investment adventure

2. Imagine that you received a surprise gift of $20,000. You decide to invest the money. Which alternative do you think is best for you over the long term?
   a. Deposit the money in a savings account, a money market account, or a similar safe investment.
   b. Invest it in safe, high-quality bonds or bond mutual funds.
   c. Invest it in stocks or stock mutual funds.
   d. Invest it in very high-risk bonds or stocks.

3. As you are planning to invest the $20,000, your financial adviser explains where your account total might be after one year. Which range would make you the most comfortable?
   a. $19,000 to $21,000
   b. $17,000 to $23,000
   c. $13,000 to $27,000
   d. $10,000 to $30,000

4. Imagine that you reached a decision about how to invest the $20,000 gift. How do you think you would feel afterward?
   a. Worried
   b. Satisfied
   c. Hopeful
   d. Excited

5. For the last five years, your $20,000 investment has returned an average of 8 percent per year. However, it loses 16 percent over the next year. What would you wish to do?
   a. Sell all of the investment.
   b. Sell half of the investment.
   c. Hold onto the investment as it is.
   d. Buy more of the same investment.

### Question for Discussion

- The questions above reflect levels of investment risk. If you most often circled "A," you are very risk averse. If you most often circled "B," you are moderately risk averse. If you most often circled "C," you are willing to take moderate risks. If you most often circled "D," you are willing to take larger risks. Which answers did you provide most often? Why?

# ACTIVITY 21.2
# QUESTIONS FOR CLIENTS

**Directions:** The following questions are designed to help you obtain important information about your clients. This information can help you provide sound financial advice.

1. **How much does the client have in savings?** Everyone should have some liquid savings in order to handle emergencies. A person with more savings may be willing to assume more risk.
2. **Is the client able to save some money each month without borrowing?** People who are able to save each month are living within their incomes.
3. **Is the client responsible for people who are financially dependent?** Having liquid savings to handle emergencies is especially important for people with dependents. People with no dependents and many years until retirement may be willing take more risks.
4. **How much risk is the client willing to take in order to pursue a higher rate of return?** Some people can tolerate no risk. Others are willing to take some risk with some of their savings in hopes of earning a higher rate of return. Remember the rule of 72 and the difference a higher rate of return makes. Also consider the risks and rewards associated with holding bonds. Some investors consider bonds safe, since the rate of return is known and, barring default, the principal will be returned. However, there is risk. If a bond is sold before maturity, the bond holder will not get the full principal back if market interest rates are higher than they were when the bond was purchased.
5. **How close is the client to retirement?** As retirement approaches, investors have fewer years to recover from a loss and will likely assume less risk.
6. **Does the client expect his or her savings to generate income?** Some investors, especially retirees, count on interest from savings and bonds or the dividends from stocks to provide income. These savers will be looking for high rates of interest and/or high, dependable dividends.
7. **Is the client primarily hoping for growth?** People who don't need additional current income but want the value of their investment to grow for future use may prefer growth stocks—ones that go up in price, yielding annual returns.

# ACTIVITY 21.3
# INVESTMENT CASE STUDIES

**Part 1: Investment Alternatives**

**Directions for Part 1:** Imagine that you are a financial planner—someone who gives advice to clients regarding their overall investment strategies, in return for a fee. Your goal is to recommend the investment strategies that best fit the financial situation and goals of your clients.

Carefully read each of the three criteria listed below and the three investment alternatives that follow. Make use of the criteria and your understanding of the investment alternatives in developing your specific advice for each client. For each client, include your top three recommendations about what percentage of his or her investment dollars should be placed in each category. So, for example, you might recommend that a client place 60 percent of his or her investment dollars in stocks, 30 percent in bonds, and 10 percent in cash.

**Three Criteria.** Here are three criteria that financial planners and their clients may consider in making investment decisions. These criteria don't automatically determine any investment decision, but they are helpful points of reference.

- ***Liquidity:*** *Liquidity* refers to how quickly an investment can be converted to cash. For example, stocks and bonds are nearly liquid forms of investments because they can be sold any day. However, there is market-price risk involved. The stock price may be lower than the purchase price. Cash—such as money held in a savings account—is more liquid. A savings account depositor may withdraw money from savings at any time, without penalty.
- ***Protection of the principal:*** *Protection of the principal* refers to risk that some or all of the investment may be lost. Such a loss might occur when stocks lose value in a market downturn (a case of market risk) or when a bond is sold before maturity at a time when interest rates have gone up (a case of interest-rate risk).
- ***Estimated rate of return:*** *Estimated rate of return* refers to the expected annual gain on an investment. Investments with low rates of return—such as money held in cash—may appear to be very safe, but their returns may be below the level of inflation. In such a case, the saver suffers a loss in the form of reduced purchasing power.

**Three Investment Alternatives (Set against the Three Criteria)**

**1: Investment in Stocks**

| Types of investment in stocks | Provides liquidity? | Provides protection of the principal? | Estimated rate of return? |
|---|---|---|---|
| Growth stocks | Yes | No | 10 % |
| Income stock | Yes | No | 3 % |
| Aggressive growth-stock mutual funds | Yes | No | 10% |
| Income stock mutual funds | Yes | No | 3 % |

**2: Investment in Bonds**

| Types of investment in bonds | Provides liquidity? | Provides protection of the principal? | Estimated rate of return? |
|---|---|---|---|
| Tax-exempt municipal bonds | Yes | Yes | 2% |
| Top-rated government bonds | Yes | Yes | 2% |
| Top-rated corporate bonds | Yes | Yes (but less than government bonds) | 4% |

**3: Investment in Cash**

| Types of investment in cash | Provides liquidity? | Provides protection of the principal? | Estimated rate of return? |
|---|---|---|---|
| Savings account | Yes | Yes (insured by FDIC) | 1% |
| Certificate of deposit | Yes | Yes | 1% |
| Money market account | Yes | Yes | 1% |

**Part 2: What's Your Best Advice?**

**Directions for Part 2:** Read and discuss the following four cases. Recommend what percentage of savings each client should place in each of the three investment alternatives. Then explain your recommendations.

**Case 1: Dan and Sue Wilson**

Dan and Sue, ages 29 and 28, are trying to get ahead financially. Dan earns $40,000 a year. Sue is a stay-at-home mom looking after their pre-school child. They would like to buy two "big ticket" items (a new house and a car), but those purchases will have to wait until they are more financially stable. Their primary objective now is to reduce debt and save more money. They have $3,000 in savings. They owe $4,000 in credit-card debt. They would also like to begin saving for college expenses and retirement. How would you advise Dan and Sue to manage their savings?

| Client | Percent in stocks | Percent in bonds | Percent in cash |
|---|---|---|---|
| Dan and Sue | | | |

Why?

**Case 2: Shannon**

Shannon, age 26, is a sportscaster for a small television station. A single mom with a six-year-old son, she gets by on an income of $25,000. With careful budgeting, she has managed to save $1,000. Her employer will match her savings in a 401(k) plan, up to $25 per month. She has worked at the station for two years; she has health insurance but no job security. How would you advise Shannon to manage her savings?

| Client | Percent in stocks | Percent in bonds | Percent in cash |
|---|---|---|---|
| Shannon | | | |

Why?

**Case 3: Jennifer**

Jennifer is 34 years old. She has no dependents and lives in a townhouse worth $120,000. Her monthly payments on the townhouse are $770. She works as a sales representative for a pharmaceutical company, earning $65,000 per year, and she has a company car. She has managed to save $12,000; she would have more money in savings, but until recently she has been concentrating on paying off her student loans; she did pay them off two years ago. She enjoys her work and feels appreciated by her employer. She has good benefits, including health insurance, a retirement plan, and profit sharing. She hopes to stay with this company. She spends her free time rock climbing and paragliding. How would you advise Jennifer to manage her savings?

| Client | Percent in stocks | Percent in bonds | Percent in cash |
|---|---|---|---|
| Jennifer | | | |

Why?

**Case 4: Antonio and Maria**

Antonio, age 55, earns $73,000 per year as a computer administrator; his wife Maria, age 56, earns $90,000 per year as the Vice President of Human Resources for a large firm. They have two grown children and four grandchildren. In addition to a $300,000 home, they own two cars, a sailboat, and a summer cottage at the beach. Both have full retirement benefits at work, and both hope to retire in five years. They have savings of $500,000. Antonio enjoys reading financial magazines, analyzing companies, and following his investments.

| Client | Percent in stocks | Percent in bonds | Percent in cash |
|---|---|---|---|
| Antonio and Maria | | | |

Why?