Time Horizon Can Determine Risk Tolerance

Key takeaways

- Fears surrounding the coronavirus pandemic and its impact on economic activity and corporate earnings have taken center stage. Investors may be reevaluating their tolerance for risk as volatility surges given the market’s recent fall into bear market territory.

- Investors’ tolerance for risk can depend greatly on investment goals and time horizon. Goals can range from generating income to growing assets. Time horizons can be short, intermediate, or long.

What it may mean for investors

- Determining investment goals, risk tolerance, and time horizon are important steps that can help lead to long-term financial success. We recommend reviewing a portfolio’s asset allocation with an investment professional on a regular basis to make sure it continues to align with investment goals, risk tolerance, and time horizon.

Fears surrounding the coronavirus pandemic and its impact on economic activity and corporate earnings have taken center stage. Investors may be reevaluating their tolerance for risk as volatility surges given the market’s recent fall into bear market territory. The S&P 500 Index selloff triggered by the pandemic caught some investors by surprise. Meanwhile, equity market volatility (measured by the CBOE Volatility Index®, or VIX®)\(^1\) has spiked to historic levels in recent weeks—exceeding levels that we observed during the 2008 financial crisis. Investors accustomed to low levels of volatility throughout the protracted bull market now likely are feeling uneasy about the resurgence of volatility.

We believe investors who are concerned about the market’s ups and downs should consider their time horizon—the amount of time investors have until they will need to sell assets in their portfolio to fund an investment goal.

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\(^1\) The VIX shows the market’s expectation of 30-day volatility. It is constructed using the implied volatilities of a wide range of S&P 500 index options.
Time horizon can influence an investor’s willingness to take on risk—it is one component that can help to align investment goals with risk tolerance. Financial markets can be extremely volatile on a short-term basis, and some investors may be unable to tolerate sizable drawdowns in their portfolios—even if those moves are only on paper. Investors with shorter time horizons may be more likely to select conservative allocations, while investors with longer time horizons (and ample liquidity—as employment loss can be a concern in today’s pandemic scenario) often are willing to take on more risk and may choose a moderate or aggressive allocation. As the left side of Chart 1 shows, over shorter time horizons, higher-risk assets, such as equities, can experience wide price swings. Diversified asset allocations generally have seen less volatility. While high-quality fixed income assets historically have had some of the lowest volatility, they may not provide enough return to meet long-term goals.


Looking out to a 10-year horizon (right side of Chart 1), historically the potential for loss has diminished—as market cycles evolved and short-term losses eventually turned into long-term gains. There is greater potential reward in equities, but the risk is higher. There is lower potential reward in fixed income, but the risk typically is lower. A diversified asset allocation (such as the one shown in Chart 1) historically has captured much of the upside in equities without generating a loss over any 10-year rolling period since 1990. Over the same period, average annualized returns for the hypothetical Moderate Growth & Income 3AG Portfolio (Chart 1) have kept up with the S&P 500 Index and have outpaced the Bloomberg Barclays U.S. Aggregate Bond Index.

Determining investment goals, risk tolerance, and time horizon are important steps that can help lead to long-term financial success. If an investor’s time horizon is short, and recent equity market volatility has been unnerving, then a conservative asset allocation may be the best approach. If an investor’s time horizon is long (and the investor has ample liquidity), the willingness to take on risk may be greater, and the portfolio’s asset allocation can lean more toward growth assets like equities. For investors whose time horizon and risk tolerance are somewhere in between (like many investors), a reasonable balance between growth assets and income-producing assets may be appropriate. We recommend reviewing a portfolio’s asset allocation with an investment professional on a regular basis, regardless of market conditions, to make sure it continues to align with investment goals, risk tolerance, and time horizon.
Risk Considerations

Asset allocation cannot eliminate the risk of fluctuating prices and uncertain returns.

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Foreign investing** has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. These risks are heightened in emerging markets. **Small- and mid-cap stocks** are generally more volatile, subject to greater risks and are less liquid than large company stocks. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. **High yield (junk) bonds** have lower credit ratings and are subject to greater risk of default and greater principal risk. Although **Treasuries** are considered free from credit risk they are subject to other types of risks. These risks include interest rate risk, which may cause the underlying value of the bond to fluctuate.

Definitions

**Moderate Growth & Income 3AG Portfolio composition:** 3% Bloomberg Barclays U.S. Treasury Bill (1–3 Month) Index, 4% Bloomberg Barclays U.S. Aggregate 1–3 Year Bond Index, 21% Bloomberg Barclays U.S. Aggregate 5–7 Year Bond Index, 7% Bloomberg Barclays U.S. Aggregate 10+ Year Bond Index, 6% Bloomberg Barclays U.S. Corporate High Yield Bond Index, 5% JPM EMBI Global Index, 21% S&P 500 Index, 12% Russell Midcap Index, 8% Russell 2000 Index, 6% MSCI EAFE Index, 7% MSCI Emerging Markets Index.

**Bloomberg Barclays U.S. Aggregate Bond Index** is a broad-based measure of the investment grade, US dollar-denominated, fixed-rate taxable bond market.

**Bloomberg Barclays US Aggregate 1–3 Year Bond Index** is the one to three year component of the Barclays US Aggregate Index, which represents fixed-income securities that are SEC-registered, taxable, dollar-denominated, and investment-grade.


**Bloomberg Barclays US Aggregate 10+ Year Bond Index** is composed of the Bloomberg Barclays US Government/Credit Index and the Bloomberg Barclays US Mortgage-Backed Securities Index, and includes Treasury issues, agency issues, corporate bond issues, and mortgage-backed securities with maturities of 10 years or more.

**Bloomberg Barclays U.S. Corporate High Yield Bond Index** covers the U.S.-dollar-denominated, non-investment-grade, fixed-rate, taxable corporate bond market. Securities are classified as high yield if the middle rating of Moody’s, Fitch, and S&P is Ba1/BB+/BB= or below. Included issues must have at least one year until final maturity.

**Bloomberg Barclays U.S. Treasury Bill (1–3 Month) Index** is representative of money markets.

**JPM EMBI Global Index** is a U.S.-dollar-denominated, investible, market-cap-weighted index representing a broad universe of emerging market sovereign and quasi-sovereign debt. While products in the asset class have become more diverse, focusing on both local currency and corporate issuance, there is currently no widely accepted aggregate index reflecting the broader opportunity set available, although the asset class is evolving. By using the same index provider as the one used in the developed market bonds asset class, there is consistent categorization of countries among developed international bonds (ex. U.S.) and emerging market bonds.

**MSCI EAFE (Europe, Australasia, Far East) Index** is a free-float-adjusted market-capitalization-weighted index designed to measure the equity market performance of developed markets, excluding the U.S. and Canada.

**MSCI Emerging Markets Index** is a free-float-adjusted market-capitalization-weighted index designed to measure equity market performance of emerging markets.

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**Russell 1000 Index** measures the performance of the 1,000 largest companies in the Russell 3000 Index, which represents approximately 90% of the total market capitalization of the Russell 3000 Index.

**Russell 2000 Index** measures the performance of the 2,000 smallest companies in the Russell 3000 Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index.

**Russell 3000 Index** measures the performance of the 3,000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market.

**Russell Midcap Index** measures the performance of the 800 smallest companies in the Russell 1000 Index, which represent approximately 25% of the total market capitalization of the Russell 1000 Index.

**S&P 500 Index** consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market-value-weighted index with each stock’s weight in the index proportionate to its market value.

An index is unmanaged and not available for direct investment.

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