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RETIREMENT

How IRA Investors Can Gauge Their Own Risk Tolerance

Investors need growth in their IRAs, but some investors can stomach more risk than others. (Newscom)

PAUL KATZEFF | 2/19/2016 Reprints

What does it take to own an IRA? Brass.

That's a one-word summation of the answer that emerges from a new study of IRA ownership traits.

"Like other investing households, the majority of IRA-owning households were willing to take some investment risk for financial gain," Sarah Holden and Daniel Schrass write in a new report for the Investment Company Institute (ICI).

The portion of IRA holders willing to take investment risk inched up in recent years, their report says. Starting in 2012 and again in 2013, 28% were willing to take substantial or above-average investment risk. That edged up to 29% in 2014. It increased to 30% in 2015.

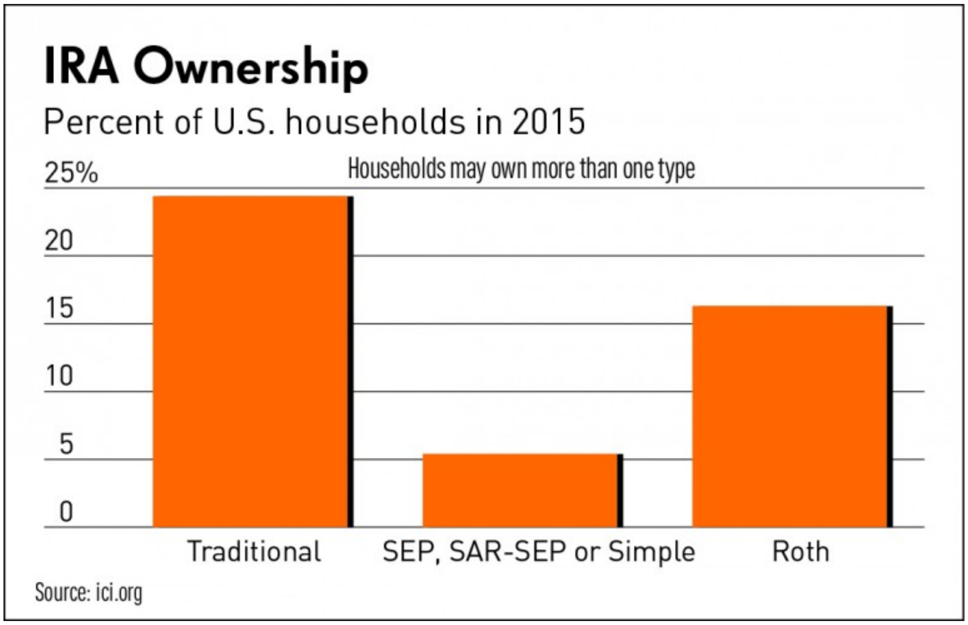
The ICI found that IRA-owning households were more willing than Americans in general to take investment risk. In the same years, only 19% of all American households in 2012 and 21% in 2013 to 2015 were willing to take a lot or above-average investment risk.

The correlation between risk-taking and IRA ownership is important for the overall retirement readiness in the U.S. because IRAs are widespread and reliance on them is increasing.

More than 40 million households had an IRA as of June 30, 2015. That was 32.2% of households. Those people's IRAs held $7.3 trillion in assets at the end of the third quarter in 2015.

That made up 31% of total U.S. retirement market assets. That was up from 18% two decades earlier.

All together, 60% of U.S. households had retirement plans through work or IRAs by 2015. That includes the 28% of households that had only employer-sponsored plans, such as 401(k)s and traditional pensions.



To many investors, risk boils down to the difference between the ups and downs they can expect from an investment in stocks in any given year and the typical lack of volatility of cash.

Large-cap stocks averaged an annual return of 10.05% from 1926 through 2015, according to Morningstar Inc. Cash, in the form of 30-day Treasury bills, averaged 3.42% a year.

“Not an investor on the planet wouldn’t want the return on stocks,” said Mark Chandik, president and chief investment officer of FDP Wealth Management, in Irvine, Calif. “But can they live with the potential downside?”

Since 1926, the worst annual performance by large-cap stocks was their 43.34% loss in the Great Depression year of 1931. Their best was a 52.62% gain in 1954.

Those swings were much wider than cash’s 0.02% setback in 1938 and its 14.71% gallop ahead in 1981.

But investors also need to know how often an investment will deviate from its usual performance. One tool for figuring that out is standard deviation, which Chandik uses to explain risk to clients. You can find the measure for every mutual fund on the “Ratings & Risk” tab of its Morningstar.com page.

The smaller the number is, the less a fund tends to veer from its average annual return. For example, $211 billion Vanguard 500 Index Fund (VFINX) has a 3-year standard deviation of 10.93. That means that in about 2 out of every 3 years — or about 68% of the time — the fund’s return will be within 10.93% of its 11.13% three-year average annual return, based on month-end results.

And about 95% of the time you can expect its yearly return to be within two standard deviations, or within 21.86% of its typical return.

The more risk you’re willing to take, the higher a standard deviation you’ll be able to stomach for any fund you’re considering for your IRA.

So you can look at the standard deviation of a mutual fund, ETF or stock and decide if you’re willing to accept the amount of price fluctuation indicated by the standard deviation.