investing: modern portfolio theory
Investing is one way to accumulate money, but the process of investing can be complicated to understand. You want your assets to accumulate, but you also don’t want to lose everything. This is why Modern Portfolio Theory was developed. In order to utilize this theory, first you’ll need to understand how it works, then determine if this theory fits your risk tolerance and behavior.
What is Modern Portfolio Theory (MPT)?

The creators of this theory wanted to find a way to maximize a portfolio’s expected return with the lowest possible amount of risk. The way they found to do this? Diversification.

A way to construct a portfolio is to take different investments and offset them against each other. This usually means a portfolio of both stocks and bonds. Generally speaking, stocks and bonds tend to have an inverse relationship. This inverse relationship often means the portfolio has limited risk no matter what the market is doing — theoretically of course.

Modern Portfolio Theory goes beyond this idea. It takes the different asset classes from large cap instruments to small cap instruments (meaning large company and small company stocks and bonds) to international investments and constructs them in a way that they have a small variance and low standard deviation. The theory suggests that no matter what the market is doing, the portfolio will continue to chug along slowly.
Determine your risk tolerance

Modern Portfolio Theory assumes a person is willing to take certain risks in order to achieve certain returns. Risk is a tricky thing to grasp. You are exposed to risks of all kinds on a daily basis. It’s why you may have insurance, but when it comes to your money, the risk takes on a new level of importance. So, what type of risk should you take with your money? Well, there are two main components to understanding risk.

First, assess your personal risk tolerance. How much investment risk can you handle? Do you lose sleep at night thinking about how your money is being invested? If so, then you likely have a low level of risk tolerance. Generally speaking, you may be able to afford to invest your money at a higher risk level when you are in your 20s, 30s and early 40s. If you’re older than that, you might need to reduce your risk tolerance because of your proximity to retirement age. This concept is called time horizon, and it’s the second factor to help you determine your particular risk tolerance.

Whether you are into taking risks or you’ve never even considered investing before, a financial professional will thoroughly assess your risk tolerance before making a move. Be sure your financial professional is willing to not only learn about you, but also willing to respect your risk tolerance. That being said, a financial professional should also challenge you, but only after a trust has been established.
What does behavior have to do with investing?

Which brings us to behavior. Modern Portfolio Theory is just that — a theory. But you function and live in the real world. Meaning human behavior often gets in the way of this theory’s plan. We do silly stuff when we get emotional. And what gets you more emotional than money? Retail therapy is just the beginning of the dumb stuff we do with money. You know how it goes. You see what the market is doing and then can’t sleep from worry. Which leads to calling your broker and moving things around until you feel comfortable. Yet, what you’ve just done is mess with the theory. If you choose to use this theory, stick it out. Panicking at a hiccup will only mess with the function of this theory.
Modern Portfolio Theory is one option to consider when it comes to how you invest. The theory is somewhat complex, but then again so is your risk tolerance. It’s possible the complexity of this theory lines up with your own particular risk tolerance. Talk to your financial professional today to determine if this theory fits in with your risk tolerance and goals.

Note: Investing involves risk which includes potential loss of principal. Investing in high-yield bonds are subject to greater credit risk and price fluctuations than investing in investment grade bonds. Please note that the use of asset allocation or diversification does not assure a profit or guarantee against a loss. Funds investing in stocks of small, mid-sized, and emerging companies may have less liquidity than those investing in larger, established companies and may be subject to greater price volatility and risk than the overall stock market. Investing in international markets involves risks not associated with investing solely in the U.S., such as currency fluctuation, potential political and diplomatic instability, liquidity risks, and differences in accounting, taxes, and regulations. Standard deviation measures the fluctuation of a portfolio’s historical returns around an average. The higher a portfolio’s standard deviation, the higher its historical volatility (variability of returns).