

# Hey Buddy, Do You Have the Correct Time (Horizon)?

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**Abstract:** *This paper describes a method used to clarify what practicing financial service professionals (FSPs) mean by the term “investment time horizon.” Based on 22 FSPs who participated in focus group discussions, five standardized time-horizon definitions were developed. The terms ultra-short, short, short-intermediate, long-intermediate, and long were conceptualized as ways an investor’s time horizon—when used as a financial portfolio input or constraint—can be categorized. This paper is presented as a step in the ongoing conversation about the way in which subjective financial services terms are currently defined.*

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**F**inancial services professionals (FSPs) and their clients often face difficulties related to contradictory time-horizon definitions used within the profession. It is possible today for one FSP to call a short-term time horizon something totally different than another advisor. This is not an insignificant issue. If, say, one FSP believes that a client who is investing for a need in two years or less is a “short-term” investor, the way in which portfolio assets are allocated will be significantly different than if an advisor thought “short-term” meant six months or less. As such, it is reasonable for clients and their FSP to ask, “What is the correct investment time horizon when developing a financial plan?” In the context of the financial services profession, this means: how are time horizons measured and what is the appropriate investment time horizon for a given goal?

In general, academicians and FSPs have avoided the task of conceptualizing and standardizing investment time-horizon definitions. This may be the result of the independent nature of FSPs who often prefer to develop their own definitions rather than collaborate with others in the development of generally recognized standards. This may also be an outcome associated with confusion about the availability and use of assets within a client’s portfolio. That is, FSPs often think of an investment as a form of deferred compensation. It is possible that FSPs might rhetorically ask if the investment time horizon is the date at which all assets are needed or the date when some assets or income is needed. It may be that the meaning and interpretation of consumption, which is

integral to the conceptualization of investment time horizons, is itself confusing, making the task of definition standardization even more complicated.

Alternatively, lack of standardization may result from the relative youth of the financial services profession. During the developmental years of the profession, much more attention was devoted to practice management models than the standardization of model inputs. According to Campbell, Chan, and Viceira, academicians have "provided surprising little guidance to financial planners who offer portfolio advice to long-term investors."<sup>1</sup> Instead of offering specific guidelines for measuring time horizons and other portfolio constraints, research-based advice has tended to focus on general rules to guide portfolio development. This has resulted in FSPs independently determining how investment time horizons are defined for their own practice purposes. Whether this is a best practice is doubtful. The purpose of this paper is to provide practicing FSPs with investment time-horizon definitions as a step toward standardizing financial portfolio inputs and constraints.

### Client Time Horizon Defined

The prospect of standardizing investment portfolio parameter inputs, particularly investment time horizons, has intrigued researchers for the better part of the past 25 years. Droms and Strauss, as an example, were among those who proposed portfolio development guidelines based, in part, on a client's investment time horizon. They noted that few existing approaches to managing financial portfolios overtly account for differences in time. Many FSPs assess investment time horizons by posing "a number of questions to potential investors, some of which deal with time horizon, then score all questions, add up the score and recommend an asset allocation based on the score."<sup>2</sup> In the model proposed by Droms and Strauss, portfolio development recommendations are explicitly described as a function of both investment time horizon and risk tolerance. They summarized the relationship this way: "An investor with a short-term horizon who has the same risk-tolerance score as an investor with a long-term horizon is assigned a much more conservative asset allocation (more debt, less

equity) than the long-term investor."<sup>3</sup> Other FSPs use a client's age as a proxy for investment time horizon. Older clients are assumed to have shorter investment time horizons than younger clients. However, there are obvious shortcomings associated with this approach, such as potentially underestimating life expectancies that result in allocating assets too conservatively.

So, what is it that FSPs are measuring in relation to time? A client's time horizon can be separated into two segments. The first is a client's decision time frame. According to Garmaise, the decision time frame is the period over which clients "measure their investment results in order to decide on the success of their investment strategy."<sup>4</sup> The second, and more universally recognized concept at least in relation to managing portfolio assets, is a client's investment time horizon. This measurement of time accounts for the period from the establishment of a financial objective or goal through the point in the future when the client's assets are needed. For short-term financial goals, the need may likely be a lump-sum dollar amount. In long-term goal situations, the need may consist of accumulating assets that will generate a stream of income over an extended period of time. It is also possible that when the client's goal has been met, the decision to postpone consumption may be made. This would entail a reevaluation of the client's new investment time horizon.

Almost always, the investment time horizon is longer than the decision time frame. The difference between these two time aspects might help explain why FSPs find it so hard to agree on common time-horizon definitions. It is possible that if a client has a short decision time frame in comparison to a long investment time horizon, the advisor may come under more intense client scrutiny, especially when market performance lags projected returns. In these situations it would behoove FSPs and their clients to have started the planning process with a clear standardized time-horizon definition. Doing so would help both the FSP and client collapse the conceptualization of decision and investment time horizons into one definition. That is, it is essential that the investment time horizon be accurately and consistently measured if an FSP hopes to prudently manage both clients' expectations and assets.<sup>5</sup>

## Examples of Financial Services Time-Horizon Definitions

While there are no standardized investment time-horizon definitions used within the financial services profession, limited attempts have been taken to create a shared understanding for evaluating the measurement of time as it relates to the management of portfolios. Table 1 provides examples of ways in which FSPs and researchers have attempted to segment time horizons into categories. The most striking aspect of the list is that there is no consistency among the definitions other than the fact that one year or less is generally considered to be

a short-term time horizon. Beyond that commonality, there is very little definitional agreement for what might constitute a mid- or long-term investment time horizon. Even more noteworthy is that there is little generalizability even in the way time horizons are described.

In general, nearly all FSPs will find the investment time-horizon definitions provided by Scott to be most familiar. Scott was among the first to suggest the need for standardized time horizons for investment purposes. She proposed that an investment time horizon between one and five years constitutes a short-term perspective. She concluded that anyone with a time horizon shorter than

TABLE 1

Time-Horizon Definition Examples

Time-Horizon Definition	Length	Source
<ul style="list-style-type: none"> <li>• Undefined Short-Term</li> <li>• Intermediate-Term</li> <li>• Long-Term</li> </ul>	<ul style="list-style-type: none"> <li>• 1 year or less</li> <li>• 5 to 10 years</li> <li>• 10+ years</li> </ul>	Scott <sup>a</sup>
<ul style="list-style-type: none"> <li>• Very Short-Term</li> <li>• Long-Term</li> </ul>	<ul style="list-style-type: none"> <li>• 1 year or less</li> <li>• 10+ years</li> </ul>	Schooley & Worden <sup>b</sup>
<ul style="list-style-type: none"> <li>• Short-Term</li> <li>• Intermediate-Term</li> <li>• Long-Term</li> </ul>	<ul style="list-style-type: none"> <li>• 3 years or less</li> <li>• 4 to 7 years</li> <li>• 7+ years</li> </ul>	Droms & Strauss <sup>c</sup>
<ul style="list-style-type: none"> <li>• Long-Term</li> </ul>	<ul style="list-style-type: none"> <li>• 25+ years</li> </ul>	Spitzer & Singh <sup>d</sup>
<ul style="list-style-type: none"> <li>• Short-Term</li> <li>• Shorter-Term</li> <li>• Mid-Range</li> <li>• Long-Term</li> </ul>	<ul style="list-style-type: none"> <li>• 1 year or less</li> <li>• 1 to 5 years</li> <li>• 5 to 10 years</li> <li>• 10+ years</li> </ul>	Rattiner <sup>e</sup>
<ul style="list-style-type: none"> <li>• Undefined Terms</li> </ul>	<ul style="list-style-type: none"> <li>• 1 year or less</li> <li>• 1 to 2 years</li> <li>• 3 to 4 years</li> <li>• 5 to 7 years</li> <li>• 7+ years</li> </ul>	Garmaise <sup>f</sup>

<sup>a</sup> M.C. Scott, "Investment Decisions and Your Personal Investment Profile," *American Association of Individual Investors Journal* (March 1993): 16-19.

<sup>b</sup> D.K. Schooley and D.D. Worden, "Generation X: Understanding Their Risk Tolerance and Investment Behavior," *Journal of Financial Planning* 16 (2003): 58-63.

<sup>c</sup> W.G. Droms and S.N. Strauss, "Assessing Risk Tolerance for Asset Allocation," *Journal of Financial Planning* 16 (2003): 2. Retrieved October 2, 2006, from [http://www.fpanet.org/journal/articles/2003\\_issues/jfp0303-art-nine.cfm](http://www.fpanet.org/journal/articles/2003_issues/jfp0303-art-nine.cfm).

<sup>d</sup> J.J. Spitzer and S. Singh, "Asset Allocation in the Presence of Varying Returns, Contribution Scenarios and Investment Horizons," *Journal of Financial Planning* 16: 2. Retrieved October 2, 2006, from [http://www.fpanet.org/journal/articles/2003\\_issues/jfp0403-art8.cfm](http://www.fpanet.org/journal/articles/2003_issues/jfp0403-art8.cfm).

<sup>e</sup> J.H. Rattiner, "Back to Basics," *Financial Planning* (May 2003): 107-108; 130.

<sup>f</sup> E. Garmaise, "Long-Run Planning, Short-Term Decisions: Taking the Measure of the Investor's Evaluation Period," *Journal of Financial Planning* 19: 1. Retrieved October 2, 2006, from [http://www.fpanet.org/journal/articles/2006\\_issues/jfp0706-art8.cfm](http://www.fpanet.org/journal/articles/2006_issues/jfp0706-art8.cfm).

one year should only invest in safe, fixed-income securities.<sup>6</sup> Rattiner reached a similar conclusion;<sup>7</sup> however, neither Scott nor Rattiner assigned definitional language to this "ultra-short-term" time horizon. Scott also categorized a time horizon between five and 10 years as intermediate, and anything greater than 10 years a long-term horizon. Although a valuable first step in standardization, these guidelines have not been broadly adopted. Instead, FSPs have continued to use their own self-conceptualized investment time-horizon definitions.

FSPs and firms tend to separately develop investment time-horizon categories based on experience and professional judgment. A long-term time horizon for one FSP, for example, may be the same as or different from a definition used by another advisor. Even so, the longer a client's investment time horizon for any given goal, the greater portfolio volatility the client should be able to withstand.<sup>8</sup> Spitzer and Singh described three ways in which time horizons influence portfolio development strategies. First, the longer a client's investment time horizon the more complicated the allocation approach becomes in order to meet the wealth accumulation target. Second, "if the proportion of wealth allocated to various asset classes is allowed to change...the number of such reallocations will depend on the length of the time horizon." Third, the number of asset reallocations will be larger the longer a client's time horizon.<sup>9</sup>

As suggested above, attempts have been made to definitionally categorize investment time horizons, but to date, no single definitional approach has been adopted within the financial services profession. The difficulty of measuring time horizons was noted by Kirby. He commented that "investors are predisposed to frequent trading" because they maintain a very short time perspective.<sup>10</sup> That is, the decision time frame for investors tends to be brief, whereas the investment time horizon used by FSPs working with clients is almost always longer. This is particularly true for investors with low risk tolerance.<sup>11</sup> Kirby concluded that anything over five years is extraordinary for the majority of investors. Nevertheless, few, including Kirby, would argue that a five-year perspective is equivalent to a long-term investment time horizon.

## Standardizing Investment Time-Horizon Definitions

A focus group method was used to help develop a methodology for arriving at standardized definitions of investment time horizons. A description of the focus group and their recommendations is presented below.

### Focus Group Participants

A focus group research methodology is appropriate when the outcome goal is to obtain feedback on a number of questions from members of an interactive group.<sup>12</sup> For the purposes of this study, 22 FSPs were brought together to discuss how important investment portfolio inputs and constraints are defined and used by FSPs. Those participating in the research were attending a financial planning conference and were recruited by the research team through personal contacts and invitations. Although some of the FSPs who participated were known to the research team prior to the meeting, existing personal relationships were not a prerequisite associated with participation. As part of the larger conference, some participants received professional continuing education credit.

FSPs who participated in the research came from diverse geographical regions in the United States. Overall, members of the focus group resembled the profile of FSPs in the United States and Canada. One half of the group classified their job function as financial planner. Others worked as insurance advisors (13%), investment advisors (18%), consultants (5%), teachers (9%), or actuaries (5%). Almost half earned their income from fees and commissions (46%). Slightly more than a quarter of participants reported earnings solely from commissions, while the remainder reporting earning only fees (14%) or salaries (13%).

Those who participated in the research were, in general, financially successful practitioners. They possessed financial planning, insurance planning, and tax planning expertise. The majority of participants (86%) were male. Participants were, on average, middle-aged ( $M = 56.15$  years of age;  $SD = 9.78$  years), and they reported having over 21 years of professional planning experience. In terms of education, the group represented a cross-section of the profession. Nearly all held an undergraduate, graduate, or professional degree. Others reported completing high school. Each participant

in the focus group held at least one financial planning credential or designation, such as the Chartered Life Underwriter (CLU)<sup>®</sup>, Personal Financial Specialist (PFS), Certified Financial Planner (CFP)<sup>®</sup>, Registered Financial Consultant (RFC)<sup>®</sup>, or Chartered Financial Consultant (ChFC)<sup>®</sup>. Almost all members of the group held a Series 7 securities license, and most were also licensed to sell life insurance and annuity products.

### Standardized Time-Horizon Definitions

As noted above, the conceptualization and use of standardized investment time-horizon definitions by FSPs and associated advisors (e.g., enrolled agents, public accounts, etc.) is almost nonexistent. There is no consensus definition of what constitutes any given investment time horizon. Focus group participants were asked to address this definitional gap in an attempt to help develop standardized time-horizon categories. Initially, focus group participants were asked if they knew of or used a set of standardized investment time-horizon guidelines. All were in agreement that such guidelines were not in existence or if they were, not widely used. The questioning then turned to a more narrow discussion of what is meant by the phrase "time horizon." In general, participants reached agreement that the time-horizon definition, as described by Garmaise,<sup>13</sup> best fit what is generally known as an investment time horizon. To be precise, an investment time horizon measures the period from the establishment of a financial objective or goal through the point in the future when the client's assets are needed. The future need may be a lump-sum value or an asset that will generate income for a client.

Once a common investment time-horizon definition was identified, focus group participants were asked their thoughts about how many time-horizon categories might be most useful to practicing FSPs and their clients. Each FSP was asked to write down the number of categories that he or she believed could be used to adequately represent investment time horizons. The anticipated outcome from this exercise was to prompt the participants to identify a balance between too many categories, which could be perceived as cumbersome, and too few, which might lead to measurement imprecision. Answers were compiled by the research team. A mean and median score for the group was calculated. The average and median

FSP figure was five; that is, the consensus was that five investment time horizons provides a reasonable balance between being useful and adequately descriptive.

Once this information was shared with the participants, they were asked to define the five categories. No time durations were provided, but preliminary descriptions, developed from a review of the existing literature, for the five categories were offered to the FSPs by the research team. These included ultra short-term, short-term, intermediate-term, long-term, and ultra long-term. However, participants did not feel that these initial categories represented the actual partitioning of time when an advisor thinks about asset allocation and portfolio management constraints. The list was rejected. Each FSP was then again asked to write down both time durations and corresponding time-horizon category descriptions that they believed would be appropriate when working with clients. Answers were compiled and analyzed by the research team. The summarized durations and category definitions are shown in Table 2. Results are similar to what others have suggested in the literature; however, the list is unique because the intermediate-term time frame has been split into a short- and long-term component.

### Application Example

An investor's time horizon acts as a mediating factor between both risk tolerance and risk capacity and the financial decision-making process.<sup>14</sup> Consider the model advocated by Droms and Strauss. They put forward the proposition that the shorter an investor's time horizon, holding other factors constant, the more conservative the investor should be when making financial decisions.<sup>15</sup> The general consensus among focus group participants was that anyone with an ultra-short-term investment time

TABLE 2

#### Standardized Time Frame Categories

Time Descriptor	Focus Group Median
Ultra-Short Term	9 months or less
Short-term	More than 9 months up to 2.5 years
Short-Intermediate Term	More than 2.5 years to 5 years
Long-Intermediate Term	More than 5 years to 10 years
Long-Term	More than 10 years

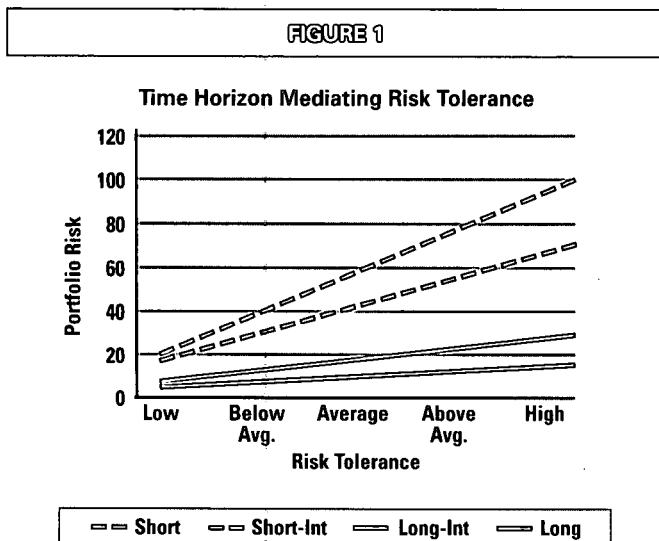
horizon—defined as the period from the establishment of a financial objective or goal through the point in the future when the client’s assets are needed—regardless of risk tolerance (i.e., the willingness to engage in an activity in which the outcomes are uncertain) and risk capacity (i.e., the ability to withstand negative outcomes associated with financial loss), should avoid systematic risk in his or her portfolio. Although not explicitly discussed by the FSPs, it is reasonable to assume that this counsel holds true regardless of a client’s age. A young client with an ultra-short time horizon should not take any more risk when investing than an older person with the same investment time horizon, assuming all other relevant client factors (e.g., risk tolerance, risk capacity, etc.) are the same.

Figure 1 illustrates how investment time horizons can mediate an investor’s risk tolerance when choosing a risk threshold within a portfolio. Each line in the figure represents an investment time horizon, as defined in this paper. (The ultra-short time horizon is not shown because, regardless of risk tolerance, no systematic portfolio risk should be taken.) The horizontal axis shows a client’s risk tolerance, ranging from low to high. The vertical axis represents portfolio risk. For the purposes of this illustration, portfolio risk is shown as a scale. In practice, risk might be measured with standard deviation or beta. Without the inclusion of standardized time horizons into portfolio development calculations, portfolio

risk would be directly associated with a client’s willingness to take risk. That is, the higher the risk tolerance, the greater the risk taken within a portfolio. In effect, the risk-return trade-off line would be similar to the long-term time horizon line shown in Figure 1 for every client. However, the inclusion of standardized investment time horizons tends to flatten out the risk-return trade-off for those with less than a long-term perspective. As shown in the figure, those with shorter investment time horizons ought to take less systematic portfolio risk, primarily because they lack the time necessary to recoup losses should their portfolio decline in value. On the other hand, individuals with both a long time horizon and a high risk tolerance can, in effect, take significantly more portfolio risk than others because they have both the willingness to sustain losses and the time available to recover any losses incurred. From a client education perspective, incorporating standardized measures of investment time horizons into the financial services profession would make risk-return trade-off decisions easier to understand. Standardization is also important in terms of comparing portfolio choices. For example, interpreting modern portfolio statistics, in the context of evaluating a client’s portfolio against another allocation framework or client outcome, could be enhanced if all FSPs used similar investment time-horizon definitions.

**Discussion**

The need for FSPs to adopt standardized investment time-horizon definitions is understandable. Consider, for example, situations where one FSP chooses, in part, to allocate a client’s assets heavily toward equities with the belief that a long-term time horizon is defined as seven years or more. What might happen if the portfolio performs badly and the client asks another advisor for an opinion about whether the first FSP’s investment approach was suitable. If the second advisor uses a definitional structure that says 10 years or more is long term, the conclusion will be that the first FSP was not prudent in conducting a suitability analysis. This outcome may lead to an arbitration and/or court filing by the client. If, on the other hand, the client obtains an opinion from an advisor who also believes that seven years is an appropriate definition of a long-term investment time horizon,



then the conclusion may be that the first FSP did nothing wrong, at least in relation to matching investments to the client's investment time horizon.

Another example could be a client who relocates to a different region of the country and seeks out a new FSP. The client's former FSP may have defined the long-term investment time horizon as 10 years or more while the client's new FSP may define long-term as seven or more years. This discrepancy in use of definitions may create confusion and frustration for the client (which may not manifest itself until it is too late). A standardized definition of investment time horizons would contribute to FSPs providing better continuity of services in order to help clients successfully achieve their goals and objectives.

These types of situations not only happen relatively often, they also can cause FSP-client communication problems, particularly when clients are faced with investment losses. For example, an FSP could be approached by a client and asked to invest the client's money on a short-term basis. Hearing this, the FSP might assume that the client meant one to three years—the FSP's definition of short term. Only later, when the account has lost money, the FSP may learn that the client needed the money to pay for a child's college tuition in nine months' time. This sort of miscommunication could be avoided if standardization of time-horizon definitions was more widely employed and communicated to clients. Further, this example illustrates the role of communication in the FSP-client relationship. Truly identifying and understanding client goals, and what is meant by an investment need, are critically important in the investment management process. Further, revisiting with clients on a regular basis about the difference between a decision time frame and an investment time horizon can help reduce conflicts that might arise. The advisor who works hard to merge a client's decision time frame into the investment time horizon adopted for the allocation of assets will be better equipped to meet the client's goals and objectives.

## Summary

The results from this focus group study suggest that it is possible to arrive at a general definitional consensus of investment time horizons that is both valid and reliable. The proposed definitions shown in Table 2 are, on initial

face value, reasonable. The definitions are similar to what nearly all FSPs most likely currently use, so there is little chance that an advisor will find the classifications unreasonable. The way in which the intermediate-term time horizon has been split makes these definitions particularly valuable. Unlike other classifications, the intermediate-term definitions proposed in this paper segment intermediate time horizons into a short- and long-term time component. This allows an FSP to better target asset allocation recommendations to a client's time horizon, given other goal, risk tolerance, and risk capacity constraints.

It is hoped that the presentation of these investment time-horizon definitions will prompt additional discussion among FSPs about the way in which financial portfolio inputs and constraints are perceived, defined, and standardized. As the 21st century moves forward, it is time for the financial services profession to begin the process of clarifying what were once historically subjective time-horizon definitions. This paper helps move the profession one step closer to that goal. Future research should address this topic on a broader level. For example, a survey could be distributed among FSPs who hold diverse credentials and represent varying financial service organizations. A larger study could help the profession move toward further standardizing investment time-horizon definitions. □

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