Do you know your risk tolerance as an investor? Some people think that because they know their attitude toward risk in general, they know about how much risk they're emotionally capable of taking with their investment portfolios.

But when financial markets decline, many of these people have a rude awakening. That's when they learn that they misjudged their tolerance for risk. Some people would never drive 90 miles an hour. But knowing that you're afraid of a car crashes is a lot different than accurately anticipating your emotional reaction to a market decline.

Some people construct overly risky portfolios, only to suffer anguish when the market drops or goes up and down like a yo-yo, known as volatility. They failed to accurately reflect on their true feelings to anticipate how they would feel when the next market decline arrived. And, if these investors had the overwhelming majority of their portfolios invested in stocks, a sudden event might present a calamity - if they panic and choose to sell. Typically, it's fear that ultimately leads to investors' demises.

Risk tolerance means not only your capacity to emotionally withstand fluctuation and temporary losses, but also your level of forbearance and discipline. If you can learn to weather negative market events - and actually taken advantage of declines by adding to your Investments at such times - you won't react by foolishly selling low. Instead, you'll remain disciplined and ultimately be rewarded for your patience when the markets resume their upward advance. Unfortunately, left to their own devices, most investors simply don't do this and thus end up with disastrous results.

Warren Buffett famously said that investing is like dieting: simple to understand, but not easy to execute. Further he said, "Success in investing doesn't correlate with IQ. Once you have ordinary intelligence, what you need is a temperament to control the urges that get other people in trouble."

A vital part of successful investing is being realistic and honest about your temperament. You can be the most intelligent person in the world and have a well-thought-out financial plan, but if you characteristically overreact to negative news and lack courage, you probably won't have the discipline to stick to your plan.

In assessing your risk tolerance, try this "financial fire drill." Ask yourself whether you'd be able to sleep at night with your current portfolio if the market suddenly declined. This drill is paramount if ultimately you want to be a "sleep-well-at night-investor."

Look in the mirror and honestly ask yourself: "How would I feel - and ultimately react - if my stock holdings were suddenly worth half their current value? What if it took a couple of years for them to come back? How would that affect my life and the lives of my loved ones?"

When we have the next 30% decline in the stock market, will you be able to sleep? How about 50%? Would you overreacted by selling all or most of your stock holdings the next day? If this would be your reaction you probably have too much invested in stocks. Consider holding a greater proportion of your portfolio in high-quality bonds, which carry lower expected returns but tend to pose less risk than stocks and usually don't go down at the same time. Bonds can serve as a portfolio buffer, much like a car's air bag.

The more market volatility you can cope with, the greater percentage of your portfolio you can comfortably commit to stocks, which offer higher expected returns in the long term but are much more volatile than most bonds. Someone with a high risk tolerance might have 80% and Global stocks and 20% in bonds, while less risk-tolerant investors might have 20% in global stocks and 80% in bonds.

Many studies have shown that most individuals overestimate their tolerance for risk and volatility. By contrast, those who underestimate their tolerance for risk and volatility maybe for going potential long-term returns on their investments.

Understanding and being honest with yourself about your own emotions as an investor is critical. Ultimately, this is the only way to construct a diversify portfolio that you will be committed to while not losing sleep.
