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Investing

The Three Faces Of Risk Tolerance

Michael Kitces offers a dissection of the most basic instincts of the investment client.

Are financial planning clients less risk tolerant than they were 12 months ago? How do you define that, and what do you do about it? In a presentation at the NorCal Conference in San Francisco, Michael Kitces offered a strong dose of clarity to the never-ending story of clients, markets and advisors.

The traditional approach, of course, is to look at the client's time horizon, determine how much income will be needed at retirement, how much is being saved, developing a needed rate of return based on certain assumptions, and then asking questions like: If the markets declined 15%, what would you do? After you've scored the client on a scale of one to five, Kitces said, and then figure out how to give the client as much risk as he/she can possibly stomach.

Kitces believe that this approach mixes up three different components of a client's risk tolerance: his/her risk capacity, risk perception and risk attitude. By breaking these out as separate components, your future course of action with any given client becomes much clearer.

Capacity, of course is the client's ability to sustain a market decline without suffering an unacceptable loss of lifestyle or quality of life now or in the future. It is a quantitatively-driven assessment.

Risk perception generally relates to how much the client knows about stocks and bonds and their historical tendency to follow a roller-coaster path that is not always comfortable. "We tend to be more afraid of things we know very little about," Kitces told the group. "Clients who have a high degree of knowledge about the markets tend to see them as less risky."

Risk attitude is more of a hard-wired part of the client's personality, the psychological propensity to take (or refuse to take) a certain risk in return for a potential reward. "Some people like to hang glide, ride motorcycles, and get a thrill out of taking risks," said Kitces. "Others hate risks and don't like losses of any kind, even if they understand the markets, even if they can afford to absorb losses."

To see how these three factors can interact in the real world, Kitces proposed that we look at John and Daniel. John needs income in 15 years, and his goal is to get $15,000 a year from his portfolio. According to the best projections you can make, the most likely scenario is that John's portfolio has a high probability of reaching $1.5 million by the time he retires. "Bad things could happen and he's still all right," Kitces told the group. "This is an example of a client who has a very high capacity for risk."

Daniel has a $1 million portfolio and wants to retire now, on $65,000 a year. If a bad market happens, his goal goes right out the window. "This has nothing to do with Daniel's risk attitude," Kitces said. "Daniel cannot afford to take much risk."

Now let's assume that both John and Daniel hate market volatility. You have John with a high risk capacity and a very low risk attitude. The traditional risk management approach would assign him a moderate growth portfolio. Daniel scores at the low end of everything, and therefore would receive a very conservative portfolio.

Right? Wrong. John can get adequate returns to meet his goals from a money market portfolio, which means he's being given risk, by his financial advisor, that he doesn't want or need. Daniel, meanwhile, is give a guaranteed path to failure. He NEEDS equity-like returns to give him the larger portfolio he needs to meet his goals.

So how can we think about this differently? Kitces suggested that we start by creating a spectrum,

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with "low required return" on the far left, and "high required return" on the far right. Interestingly, these opposite poles are associated with counterintuitive risk capacity; the far left, where we need lower returns, is associated with a "high risk capacity" precisely because the client is well on the way to achieving goals, and a setback can be absorbed. On the right side of the spectrum, where we higher returns are required, the risk capacity is low. Any bad market event will cause the plan to fall apart.

"The paradox is that those with a high risk capacity will have a very wide spectrum of possible portfolios, depending on the client's risk attitude," said Kitces. "It could range from putting the money in a mattress all the way to being all-in with equities." The low-risk capacity client has a much slimmer chance: he/she will need a high stock allocation AND have good things happen in the market.

Where does risk attitude fit into this matrix? It becomes a constraint on how far along the spectrum the client's portfolio can go; that is, it defines a set of possible portfolios for a client based on where they fit on the spectrum. In a typical example, a client might have a moderate risk capacity and a moderate risk attitude. In that case, the advisor can recommend a portfolio somewhere inside a band that sits across the center of the spectrum--60/40. 50/50, 40/60. In the case of John, the capacity spectrum is fairly broad, extending from the far left almost all the way to the far right. But since he has a low risk attitude, his band of possible portfolios will be constrained to the left side of the spectrum, and you might recommend a 20/80 mix, 10/90 or even 100% laddered bonds or CDs.

The most interesting case is Daniel. His risk capacity places him fairly fair over to the right side of the spectrum, but his risk attitude band cannot be placed anywhere on the right half of the line. Since there is no overlap, there is no possible solution; that is, Kitces pointed out, the goal is incompatible with the risk attitude. "People with a low risk attitude cannot afford risky goals," he said.

At this point, we haven't talked much about risk perception, which turns out to be the key variable during these market downturns. How so? Kitces cited research by the FinaMetrica organization, showing that people globally are scoring about the same on its risk tolerance questionnaires as they did at this time last year--and, indeed, that people are just as likely to hang glide (or not), gamble (or not), or ride mountain bicycles on steep trails (or not) regardless of what the market does. In other words, the risk attitude tends not to be changed even if your portfolio is down 65%. "If I'm willing to make a certain tradeoff," Kitces told the audience, "then I'm pretty much always going to be willing to."

What DOES change is your risk perception. "Ask people today what they think the return on the stock market is going to be over the next year, two or ten years," said Kitces, "and they are likely to give you a much lower number than they would have given you twelve months ago. They believe the markets contain more risk today than they did before they went down. Meanwhile, back in 1999, people thought the markets had no risk. Their perception of whether their portfolio can achieve their goal swings wildly."

The point here is that what we have come to call "risk tolerance" has two variables, one relatively stable, the other fluctuating with the markets, and this second (fluctuating) component--risk perception--can be addressed with education. Kitces showed the same chart, with the same spectrum between high risk capacity/low return requirements and low risk capacity/high return requirements, and showed a random band within that spectrum which defines a person who might have gotten a "4" out of "5" score on a risk tolerance questionnaire. The markets go down dramatically, as they did last Fall, and suddenly the client views that "4" band as a "5" or "6."

In the real world, that means that advisors have to be constantly resetting and reframing client expectations about the markets, educating them about the normal ups and downs that they can expect, and showing them during bull markets that downs follow ups, and that ups follow downs when they're mired in a bear market environment. Okay, yes, you knew that, but now you recognize exactly where that constant reeducation fits

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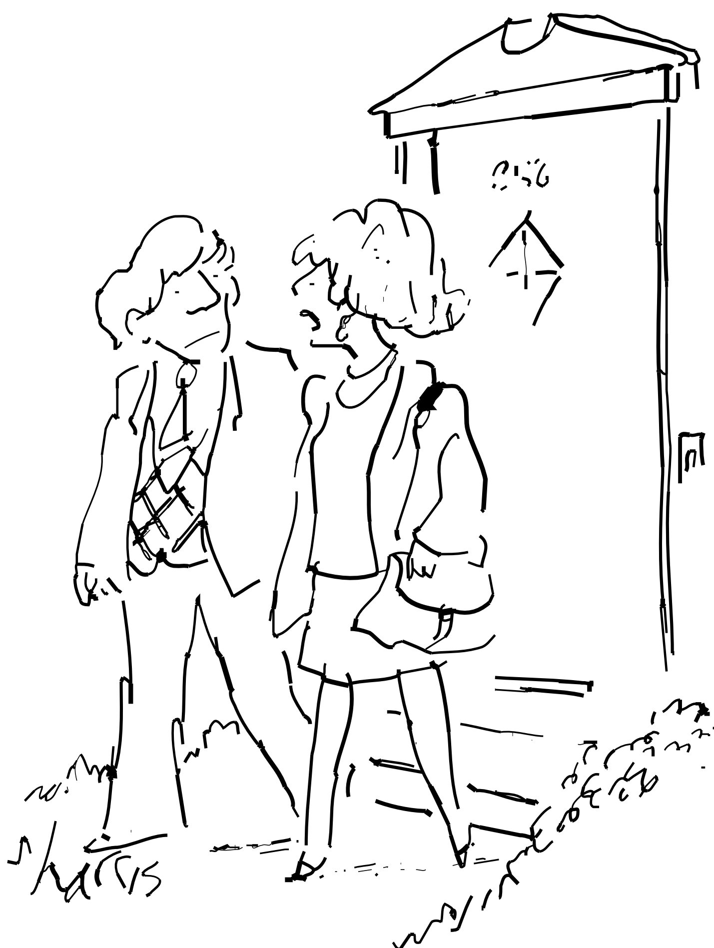
into the overall risk tolerance issue with clients. When clients look at their portfolio and think it falls outside of the bands that their risk attitude defines, you have to help them see it from a more informed perspective.

Toward the end, Kitces suggested that advisors are probably pretty good at defining a client's risk capacity, although they may not be thinking of it in those terms. "I'm a big fan of the safe withdrawal rates discussion using Monte Carlo analysis," Kitces confessed. "If you say your chance of success is X%, that takes you right into the risk attitude discussion."

Meanwhile, he thinks you can judge a client's risk perception based on the markets-- people tend to underestimate risk in a bull market, and overestimate it when the bear is growling--and also by how familiar the client is with market ups and downs.



"Daddy says this is our last date until he's had a chance to review your investment portfolio."

Risk attitude is a little harder. Kitces said that some advisors are good at intuitively guiding the conversation and instinctively getting to a good answer, but he said that a lot of advisors seem to think they're better at making this judgment than perhaps they really are. He mentioned the online FinaMetrica evaluation tool (www.finametrica.com) as the most scientific way to get this information, and said that without some kind of objective instrument, many of us have a strong tendency to let our own views and beliefs contaminate the process. "If client's don't want a high-stock portfolio, even if you believe that will get them higher returns, that's their right," he said.

By the end of the presentation, it was clear that several things happened invisibly last Fall while the markets were falling apart. Some clients, who were in appropriate portfolios despite their low risk capacity, pulled the unlucky ball out of the urn and are now going to have to change their goals. They took their chance to achieve a risky outcome, and the bet failed. Most, who were not living at or near the far right (low risk capacity) edge of the spectrum absorbed the body blow and will probably be all right, but they almost certainly believe that they're taking more risk than they signed on for. Your mission there is to reframe and reeducate.

Finally, clients who lived out on the left (high risk capacity) end of the spectrum probably shouldn't have been asked to take on as much volatility as they did. Those clients can now be gradually reset at a lower risk level--with a procedural justification to make the move. Kitces gave us a model that helps us sort out the trauma and its effects. The rest is up to you. ■