

Reports of the Death of Risk Tolerance Are Greatly Exaggerated

By *Geoff Davey Co-Founder, FinaMetrica*

October 26, 2009

Since the stock market decline a year ago, there has been much talk of permanent decrease in investors' risk tolerance. Many investors' losses were staggering, goes the refrain, so their tolerance for risk will, for the foreseeable future if not a generation, be substantially lower. Our hard data show otherwise. Average global monthly risk tolerance scores of advisers' clients in the U.S., Australia/New Zealand and Canada from January 2007 to December 2008 show a pattern of decline of only about three points (on a 0 - 100 scale) in each of these countries from earlier scores that ranged from a total of about 52 to about 57 points—less than a third of the standard deviation.

Even more convincing is the evidence from a worldwide study [worldwide study](#) that compares the scores of 3,000 client investors whose risk tolerance was tested in the first half of 2007 and again after mid-2008. The longest period between the first test and the second was 27 months and the shortest, 13 months. Again, the decline in risk tolerance was only about one-third of the standard deviation.

One implication of these findings and other research is that investors may not be as reluctant as many in the asset management industry now fear—at least, not for reasons stemming from changes in risk tolerance.

Risk tolerance is a personality characteristic. Like other such characteristics, it can be altered by an individual's reaction to major life events – divorce, a death in the family or a market drop that devastates retirement plans; the market decline doubtless has had that effect on some individuals.

Yet the data show that average risk tolerance is sufficiently stable to the point where changes in investor behavior cannot be attributed to it. What else would explain this changed behavior? There are indications that it may be attributable to changes in two other elements of risk: risk perception and risk capacity. To understand risk tolerance, it's important to understand how it differs from these other two risk elements.

A good example of risk tolerance is when you're a passenger in a car that's going under the speed limit. The speed feels right to the driver, but not to you. You feel as though the car is creeping along. But if the driver is your 16-year-old son, you'd probably see the speed as appropriate

because your risk tolerance for your child's driving is lower than for your peer's.

Perceived risk is an individual's current notion of the risks inherent in a particular course of action – in investing, the alternatives being considered. I have friends over 50 years old who ride motor scooters because they're unaware of statistics showing that that people in that age group are likely to have scooter accidents. The reason that they're not reluctant to ride is that they perceive less risk than actually exists.

Risk capacity concerns whether an individual is capable of withstanding a negative outcome. A person's risk capacity for investing is the degree to which his or her financial situation can bear losses. Suppose your mother decides that she'd like to learn to ride a skateboard, so she buys one over your objections. She's aware of the risk and has the appropriate tolerance for it, but she lacks sufficient risk capacity because her bones can't take the impact of a bad fall. So you give the skateboard to your eight-year-old son and suggest that he give it a try. He resists because he has friends who have had bad accidents. He has the risk capacity – young bones – but his risk tolerance is too low for skateboarding.

Risk perception may be a dominant factor in changes in investor behavior. We currently have a major research project under way using data from various sources, including surveys of clients and advisors on the global financial crisis and 8,000 test/retest records from our database of hundreds of thousands of completed risk profiles. Interim results show that perceived risk has increased markedly since the market declined. About 33% of these clients perceive considerably more risk and 38%, somewhat more risk. As losses reduce net worth and hence, an investor's capacity for risk, reduced risk capacity is probably another factor in investors' behavioral changes.

The good news for fund companies is that investors might be nonetheless inclined to make new investments if the more likely causes of their reluctance were to change – if their risk perception were to decrease or their risk capacity were to increase. If investors whose risk tolerance hasn't declined have good reason to perceive the market as gradually becoming less risky and gain risk capacity because of new investment capital – e.g., from salary growth or inheritance or liquidity events such as extraordinary bonuses or the sale of a business – then they would be inclined to invest this new money.

As investors' risk tolerance hasn't actually declined, according to our data, this hypothetical investor may eventually prove far more typical than many in the industry might expect.

Geoff Davey is cofounder of FinaMetrica (www.finametrica.com), a Sydney, Australia-based company that specializes in quantitative risk profiling for advisory clients. Discussions of data referenced in this article are posted on the firm's public site, www.riskprofiling.com.