

Risky Business

By Geoff Davey

It's a jungle out there and, while sometimes beautiful and even exhilarating, jungles also are risky. We talk to our clients all the time about risk, and compliance departments dedicate an enormous percentage of their time to ensuring that the investors understand the inherent risks in the financial markets. But even with all the ostensible focus on educating clients about risk, many advisors are not providing enough—or the right kind of—education about the nuances of risk. It may be because they themselves are not clear. Understanding the four primary elements of risk can help you build better relationships with clients and secure your practice.

Risk has four primary characteristics:

Risk tolerance—the risk normally chosen by the client—a personality characteristic

Risk capacity—the risk the client can afford to take—a financial consideration

Perceived risk—the risk involved in the alternatives being considered, as seen by the client

Required risk—the risk associated with the return required to achieve the client's goals, a financial projection

Risk Tolerance

Risk tolerance is a psychological element. It's a measure of how an individual feels emotionally about taking risk. Where does the person strike the balance between getting a favorable outcome versus an unfavorable outcome?

Here's an example that helps to explain risk tolerance: Have you ever been a passenger in a car when the driver seems to be going very fast—or very slowly? The speed obviously feels right to the driver, but you're feeling uncomfortable. Either you're anxious

that there will be an accident, or you're antsy, wondering why he or she is just creeping along. Lots of factors are involved in driving behavior, but a key element is the driver's tolerance for risk. Obviously the fast driver has a risk tolerance higher than yours, and the slow driver's risk tolerance is lower than yours.

Risk Capacity

Risk capacity has to do with whether the individual's financial situation can withstand the impact of a negative outcome. For instance, if someone were borrowing assets to invest—either borrowing against their other assets or borrowing on margin—in the case of a bad outcome (like the recent market environment) this person could be wiped out because he or she was exceeding their financial risk capacity. Others who invested in the same scenario without borrowing may not have been wiped out, though they might find it more difficult to achieve their goals.

Here's another way to understand risk capacity. Imagine that your mother decides she'd really like to learn to ride a skateboard, so she goes out and buys one. You try to talk her out of it, because while she may have the appropriate risk tolerance—after all, she was the one who decided to try it—she doesn't have the appropriate risk capacity because she easily could break a hip or end up with something equally incapacitating. So you give the skateboard to your 8-year-old son and suggest that he use it. He doesn't want to try it because he knows that his friends have had accidents and he doesn't want to get hurt. This is just the opposite situation. He has the risk capacity—he's not likely to break anything and even if he does, he'll recover quite easily. But he

obviously doesn't have the tolerance, i.e., the psychological inclination, for this type of risk.

Advisors are readily able to evaluate risk capacity by analyzing the client's financial circumstances; however, the measure of risk tolerance is more nuanced.

Perceived Risk

Let's take a look at an example of perceived risk. A few of my peer group have bought motor scooters just to get around, for short trips. They don't see this as carrying a risk, yet statistics show that people older than 50 who ride motor scooters are likely to have accidents. But most of the people who buy motor scooters are not aware of the statistics, so their perception is of a much lower risk.

Some of the people who bought subprime investments—the ones that originally were touted as having AAA ratings—didn't realize they were taking a risk. We now know that the ratings of those investments may have been problematic, but the investors saw the AAA rating, bought the investment, and didn't perceive the risk as being as high as it was.

Required Risk

This aspect of risk is actually the return that is required to achieve stated objectives. Taking a client's circumstances, resources, and goals as inputs, advisors can use planning software to determine the return required to achieve goals; there will be a level of risk associated with that return, hence a risk required.

Of course, the first time the inputs are fed through the software the return required might be impossibly high, e.g., inflation plus 20 percent, in which case some reality checking and goal



reviews will be needed to bring the return required down to a level that is at least feasible.

These four elements of risk—tolerance, capacity, perception, and required—all come into play when advisors sit down with clients to do financial planning, and all are important. What is absolutely essential, however, is that advisors 1) recognize how these elements are distinct and 2) ensure there is no confusion when it comes to making investment decisions.

Risk-Profiling Questionnaires

Most advisors use some form of risk tolerance questionnaire. It may be one provided in their planning software or by a product supplier, or it may be a required element from a compliance department. Typically, the client completes it quickly, often with the advisor's "assistance." Then one of two things occurs: Either the advisor moves on to the "real" portfolio design process or, even worse, the risk tolerance questionnaire itself is used to select an investment portfolio directly. This type of profiling is known as a portfolio picker: Questions are asked about goals, experience, risk capacity, etc., to select one of five or six investor "styles," each of which has its own model portfolio.

Portfolio pickers have been shown to be a flawed methodology in several research studies. Their shortcomings, together with an introduction to the principles of good measurement, can be found in "Insights on Measuring Risk Tolerance from Psychology and Psychometrics," a paper co-written by myself and two U.S. academics, Michael Roszkowski, PhD, and John E. Grable, PhD, CFP®.¹

The other option is a psychometric profile. Questions for this type of profile have been selected after a rigorous process of usability and norming trials. Questions are tested for understandability (how easy the question is to understand) and answerability (how easy the question is to answer.) These

trials ensure that the questions are in plain English and can be understood by the client without explanation by the advisor. Questions with high usability then are subjected to norming trials, which test the statistical qualities of each question and of the scoring algorithm.

consider and resolve conflicts between competing risk-related parameters.

Bob's advisor shows him that he needs a very aggressive portfolio to achieve his life's ambitions. However, through questioning and analysis the advisor discovers that Bob can afford

“ A psychometric test will provide an accurate score with a small known margin of error, on a known scale, and a meaningful verbal report. ”

A psychometric test will provide an accurate score with a small known margin of error, on a known scale, and a meaningful verbal report. There also should be a technical manual that provides details of the trials and the results. It sounds complicated because it is. But the complexity resides with the development of the questionnaire, not with its use with clients; that's its beauty.

The fact is, portfolio pickers ask too few "good" questions and too many "bad" questions. Whether a particular question is good or bad can be determined only by the type of complete analysis described above; however, it is possible to use a simple sight check to do an initial culling of questions that are off the topic or will require explanation by an advisor.

Questions about time horizons, cash flow requirements, investment experience, and the like, while all of interest to the advisor, should not be included with risk tolerance questions because they will only distort the result to the point where there is no reliable outcome.

Unfortunate Trade-Offs

The following simple example illustrates a typical financial planning trade-off situation. Bob is deciding which portfolio best suits his needs and is worthy of his properly informed commitment. With his advisor's assistance, Bob needs to

to lose no more than 10 percent of his investment assets without having his life's ambitions markedly changed, which means a conservative portfolio. By assessment, the advisor discovers that Bob has a low-ish risk tolerance that, all else being equal, would lead him to a moderate portfolio. Clearly three different asset allocations leading to three distinctly different lifestyle outcomes are competing here. Here are the questions that need to be addressed:

- Is any one of them right for Bob?
- Which allocation causes Bob the greatest anxiety and which the least anxiety?
- Are there alternatives?
- What is the right way to proceed, recognizing the substantial differences in long-term outcomes?
- How should Bob make those decisions?

In the end, Bob must be the one to make the decisions because he is the one who has to live with the consequences. He must give his properly informed commitment to the asset allocation that will be implemented. Exploring the trade-offs is usually a powerful educational experience about risk and return. The advisor's role in this process is to suggest alternatives, to illustrate outcomes, to recommend—but not to decide.



This process commonly is called a Gap Analysis and usually is resolved by clients through a combination of:

- increasing the resources applied by earning more and/or spending less
- converting personal-use assets to investment assets
- easing the goals through delaying, reducing, and/or discarding
- taking somewhat more risk than preferable (but not so much that in a downturn they might panic and sell)

This process, as outlined for Bob, is at odds with much of current standard industry practice where portfolio pickers automatically make trade-offs opaquely (based on the portfolio picker's values rather than Bob's values). This "pragmatic" short cut runs a high risk of a poor match between the investor's needs and the recommended portfolio. At best this is just plain wrong; at worst it results in the following:


- greater risk of client unhappiness
- higher levels of product churn
- more likelihood of both informal and formal dissatisfaction and complaints

It's not surprising then to find that most advisors place little stock in today's risk tolerance questionnaires. Some are skeptical about whether questionnaires are capable of measuring much. Others seem to doubt whether risk tolerance is something that can be measured in the first place, while still others believe that risk tolerance is so unstable that there is no point in trying to measure it. Of course, many advisors have witnessed cyclic client behavior patterns—clients seek risk in bull markets and avoid risk in bear markets.

For some practitioners, it's all too easy to use this as an excuse to inquire no further. What's really necessary is to explore in greater depth exactly what risk tolerance is, how to measure it, and how it fits into the financial planning process.²

In "The Economics of Loyalty," a study sponsored by Vanguard, Julie Littlechild, president of Advisor Impact, shows that engaged clients remain with

their planners longer and generally offer qualified referrals.³ An easy and effective method of engaging clients and building trust is by a thorough understanding of their unique financial risk tolerance.

Comprehensive financial risk tolerance tests give reliable, in-depth insight into clients' financial attitudes, values, motivations, preferences, and experiences. By making risk tolerance explicit and understandable, clients are more confident of the advice and more committed to the planning process. 

Geoff Davey, co-founder of FinaMetrica®, specializes in risk tolerance and its role in financial

planning. He earned a B.Sc. from the University of Melbourne. Contact him at geoff.davey@finametric.com.

Endnotes

- 1 See Michael Roszkowski, John E. Grable, and Geoff Davey, 2005, Insights on Measuring Risk Tolerance from Psychology and Psychometrics, *Journal of Financial Planning* (April), available at http://www.fpanet.org/journal/articles/2005_Issues/jfp0405-art8.cfm.
- 2 A variety of free tools and reports is available at www.riskprofiling.com.
- 3 See Vanguard, The Economics of Loyalty, available at https://advisors.vanguard.com/iwe/pdf/FASJLC.pdf?WT.mc_id=1108econofloyalty.