Linking Risk Tolerance to Portfolio Risk

By Geoff Davey

A client's risk tolerance affects all financial decision making, but usually is most critical in the decision regarding a long-term investment strategy. Here the conventional wisdom is that the longer the term, the higher the risk that can and should be taken. However, a client with a low risk tolerance who takes on a high-risk strategy is inviting disaster.

As we saw in the 2008-09 bear market, clients who are overexposed to risk can find the pain of a major downturn to be unbearable with no alternative but to bail out.

Risk Tolerance Resources

Geoff Davey has several examples of a valid risk tolerance questionnaire on www.riskprofiling.com. In addition, a recording of his spring 2010 seminar, Best Practice Risk Profiling, is available to PFP Section members, along with presentation materials. Section members may register for a free 30-day trial of the FinaMetrica system and are eligible for a 10% discount. The FinaMetrica methodology can be seen in full in the QuickStart Guide, the Linking Spreadsheet and its Guide, and the Risk and Return Guide, all available as free downloads under Resources at *www.riskprofiling.com*.

Unfortunately, this usually occurs at or close to the bottom, and when they stay out of the market for an extended period, they miss the recovery. This can do great damage to a client's emotional and financial well-being, which may lead to the client seeking someone to blame. The relationship with their planner is likely to end acrimoniously and may finish up before a tribunal or in court. Obviously, this is in neither party's interest.

It is easy to say that somebody with low risk tolerance should not be in a high-risk portfolio, but this thinking presupposes that the planner can make a valid and reliable estimate of his or her client's risk tolerance and then compare that with the level of risk in a portfolio.

The second article in this series, "Using Psychometrics to Assess Risk Tolerance," demonstrated how a planner can meet the first leg of that challenge. Let us now consider the second leg.

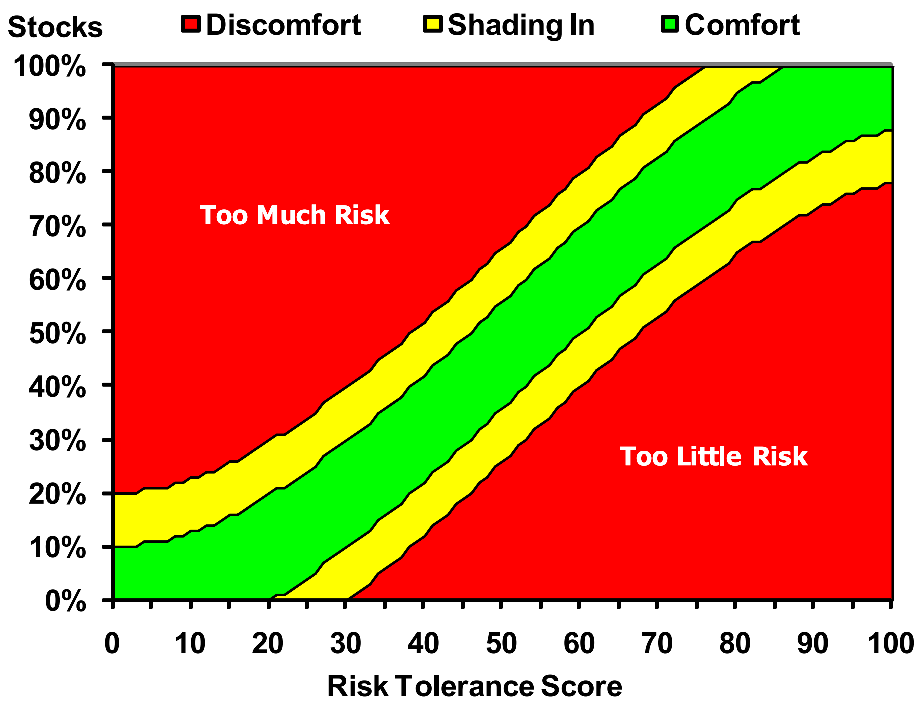
Planners typically are significantly more risk tolerant than clients and this can cause them to overestimate the client's risk tolerance and, underestimate the risk in a portfolio. As a result, a real danger exists here, so an objective rather than intuitive approach is what's needed.

Such an approach can be demonstrated using the FinaMetrica methodology that is based on research involving 20,000 client risk tolerance tests and monthly historical performance data going back to 1972. In particular, how clients answered questions regarding preferred portfolios, downside volatility, and expected returns was compared with performance data for a representative set of portfolios. This research enabled a client's risk tolerance score to be mapped to the percentage stocks in a portfolio. So, for example, an average score of 50 mapped to 47% stocks.

However the volatility of a portfolio is not particularly sensitive to the percentage of stocks. A client who is comfortable with 47% stocks is also going to be comfortable with 48%, 46%, and so on.

Figure 1

Linking Risk Tolerance to Portfolio Risk



In this context, it needs to be remembered that risk tolerance is not an upper limit on a negative but, rather, a balance point between too much and too little risk. Although a client will not want to be overexposed to risk, thereby putting his or her financial well-being in danger, neither will he or she want to be underexposed to risk and to miss out on opportunities.

The aim here is not so much to be precisely right but, rather, to avoid being badly wrong. At all costs, planners must strive to avoid situations in which a client's risk tolerance indicates a 30% stocks portfolio, but the client is in a 70% stocks portfolio. This is a ticking time bomb.

Using the FinaMetrica methodology as an example, both the balance-point and shading-in concepts are illustrated in figure 1, in which the 0–100 risk tolerance scale is mean 50 with standard deviation of 10.

Most of the time, planners deal with too-much-risk situations. Typically, clients cannot achieve their goals from resources available at a level of risk consistent with their risk tolerance. This will require some trade-off decisions to be made by the client, which will involve the following:

- Easing goals by delaying, reducing, or forgoing less important ones.
- Increasing resources by earning more, spending less, or converting personal use assets to investment assets.
- Taking more risk but not so much as may cause a panicked sale in a downturn.

Occasionally, planners come across too-little-risk situations in which a client's goals are modest, given the available resources, and those goals can be achieved well within their risk tolerance. In these happy circumstances, the client has the option to adopt more ambitious goals, spend more or convert investment assets to personal-use assets, or simply go with a less risky strategy.

When there is a mismatch between the client's risk tolerance and the risk required to achieve the client's goals, it is important that the client make the trade-off decisions rather than the planner. The planner's role is to suggest and illustrate alternatives, explain consequences, and provide guidance—but not make the decisions. This is the client's life, and it must be the client who makes the ultimate decisions.

From the planner's perspective, guiding clients through this process demonstrates the planner's expertise and results in properly informed clients who are committed to their plan because they understand what they are doing and why they are doing it. Such clients are more confident, sleep better, are easier to service, and are more likely to refer. ■

About the Author

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